STATE OF CALIFORNIA

SENATE SELECT COMMITTEE TO INVESTIGATE

PRICE MANIPULATION OF THE WHOLESALE ENERGY MARKET

HEARING RE: NATURAL GAS INVESTIGATION UPDATE

STATE CAPITOL

ROOM 112

SACRAMENTO, CALIFORNIA

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Reported by:

Evelyn J. Mizak
Shorthand Reporter

APPEARANCES

MEMBERS PRESENT

SENATOR JOSEPH DUNN, Chair

SENATOR WES CHESBRO

SENATOR K. MAURICE JOHANNESSEN

MEMBERS ABSENT

SENATOR DEBRA BOWEN

SENATOR MARTHA ESCUTIA

SENATOR BETTY KARNETTE

SENATOR SHEILA KUEHL

SENATOR WILLIAM MORROW, Vice Chair

SENATOR BYRON SHER

STAFF PRESENT

IRMA MORALES, Committee Assistant

LARRY DRIVON, Special Counsel to Committee

ROBERT PRATT, Legislative Counsel

CHRIS SCHREIBER, Consultant

ALEXANDRA MONTGOMERY, Consultant

RONDA PASCHAL, Consultant

ALSO PRESENT

SENATOR GLORIA ROMERO

PAUL R. CARPENTER, Principal
The Brattle Group
Economic, Environmental & Management Counsel
Cambridge, Massachusetts

MATTHEW P. O'LOUGHLIN, Principal
The Brattle Group
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TRINA HORNER, Advisor to President LORETTA LYNCH
California Public Utilities Commission

BILL JULIAN, Advisor to Commissioner CARL WOOD
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Houston, Texas

MATTHEW KIRTLAND, Attorney for Ms. Markey
Fullbright and Jaworski

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P-R-O-C-E-E-D-I-N-G-S

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CHAIRMAN DUNN: Good morning, everybody. What we're going to do is, we're waiting for Senator Johannessen to arrive. He is on his way down from his office.

Let me take care of some procedural issues first. I want to lay out what the schedule of the day will be. Don't worry. For those who have been long time attendees, I would not even try to estimate the length of time today because I know whenever I do it, you can guarantee three times that length.

But we have three panels that will be testifying: two this morning, and the third at approximately 1:00 o'clock or so this afternoon. The first one will be representatives from The Brattle Group, who are all ready in place and ready to go. Their testimony, just to give everybody a little bit of insight as to each of the three panels, from our discussions with them will be testimony regarding how the natural gas can be manipulated, both price and supply. That will be done through an examination of the refund case that is currently pending before the FERC.

The second panel will be the PUC, who is going to talk about the gas price indexing in more detail and its importance.

And then our third panel, which as I stated, will be at approximately 1:00 o'clock no matter when we finish on the first two panels, is going to be about how the gas price indexes were created, and subject to manipulation, and how it occurred.

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The individual that will be testifying, we believe, is central to that information. It's an individual who was on the inside. Some would refer to this witness as a whistle blower today. We have been in discussions with the witness and witness's lawyer regarding the extension of immunity. That will all occur, as I said, in that third panel starting at approximately 1:00 o'clock, no matter when we finish with the first two panels.

I want to go to a little bit of background on what else we've been up to the past few months since we have not been here and in session. We've had a number of questions about certain topics, such as Perot Systems, and whether we are through in our examination and do not intend to revisit that issue. That is wrong. We will be revisiting the Perot Systems issue. We have been spending most of the fall examining additional documents that have been produced by Perot Systems. The review of those produced documents has, in our view, uncovered additional disturbing documents that we intend to visit directly with the Perot Systems representatives.

In addition, there are many documents that have been withheld on a claim of privilege. We have been seeking for a very long time the privilege log from Perot Systems. As of this date, we still do not have it. I cannot even tell you when we expect to get it. If we need to visit the issue of contempt on that particular issue, we will do so.

Also with respect to Perot Systems, many of the documents that were introduced were redacted in many large portions, another issue we will wrestling with Perot Systems about.

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On the ISO side, in our long-standing love-hate relationship with ISO, there are additional issues we are going to be pushing. One that we have been working with ISO on throughout the fall is the discovery that ISO actually shut off power line capacity at a very critical time in the energy crisis, thus curtailing the amount of electricity that was subsequently available to California. We believe they did that without actually informing anyone of that fact. That's an issue we're going to explore in more great detail at a later time.

We are also continuing our follow-up with what the industry has labeled as, quote, "The Lynch Report," end quote. As far as follow-up, we have received lengthy correspondence from most of the impacted stakeholders in the report that was presented here by Loretta Lynch several months ago. Of course, those are responses that we are following up on and seeking additional input from the PUC. With it, of course, one has to look at the recent revelations from the Williams AES situation as a result of FERC's releasing to the public the transcripts. We are still critical of FERC's behavior in that regard, and why that information was withheld for the length of time, in our view, is simply without any basis. I hope, again, that FERC will change its modus operandi in how it investigates and withholds information.

We're also continuing the examination of municipal electricity systems. As everyone is aware, Senator Bill Morrow and his office are the architects of that aspect of the investigation. Some of you may be aware that during depositions taken by Senator Morrow's office recently of

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Glendale representatives, one of their representatives did, in fact, plead the Fifth Amendment in response to a certain line of questions. We will be exploring that also in the coming weeks as well.

And as far as additional hearings we're expecting, I'm working with leadership as far as how much longer the Committee will continue its work, and then we'll decide, on a priority basis, which hearings are likely to occur and which not, of course keeping everybody posted. You all know that our office is an open door, and feel free to call any time if you have any questions that you need to answer.

We're still waiting for Senator Johannessen. I think, however, we will start at this point in time. We have been set up as a subcommittee to act today. It is a subcommittee of three. As soon as Senator Johannessen is here we will have a quorum; we will establish the quorum at that time and proceed accordingly.

Let's proceed forward. Bob, are you ready for your duty? Our two witnesses, if you would, we need to swear you in as we do for all witnesses.

Before we do that, Senator Johannessen, welcome.

Irma, if you can call the roll of our subcommittee of three, just the three, including Senator Chesbro.

SECRETARY MORALES: Chairman Dunn.

CHAIRMAN DUNN: Here.

SECRETARY MORALES: Chairman Dunn here. Senator Johannessen.

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SENATOR JOHANNESSEN: Here.

SECRETARY MORALES: Senator Johannessen here. Senator Chesbro.

CHAIRMAN DUNN: For those of you who are following, Senator Chesbro will be here as we go forward. He is in the building today.

[Thereupon the witnesses, PAUL R. CARPENTER and MATTHEW P. O'LOUGHLIN, swore to tell the truth, the whole truth, and nothing but the truth.]

CHAIRMAN DUNN: Mr. Carpenter, Mr. O'Loughlin, I understand that you have prepared for us today a presentation that I'd like to invite the two of you to go through. Please pardon us if we interrupt throughout it with follow-up questions, and at the end, I hope that you will make yourselves available for Q and A for further input as well.

Let me turn it over. I don't know, Paul or Matt, which one is going to take the lead. Paul, let me turn it over to you and start, if you would, with the introductions of the both of you, and then take it from there, please.

MR. CARPENTER: Thank you very much.

Can everybody hear me?

My name is Paul Carpenter. I'm here today with my partner, Matthew O'Loughlin. We are principals of The Brattle Group, which is an economic consulting firm based in Cambridge, Massachusetts.

Just by way of a little bit of background, Matt

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and I have been involved in California energy matters now for at least 15 years, and we've been keen students of how the market has performed throughout that time period, and have been actively involved in a variety of proceedings evaluating the market and its performance.

By way of educational background, I have a Ph.D. in economics from MIT. Matt has an MBA from the Wharton School at the University of Pennsylvania.

The material we're going to go through with you today is primarily based on research that we've done over the past two years on behalf of Southern California Edison and other California parties in the CPUC's complaint case before the FERC, the complaint case regarding El Paso Natural Gas and El Paso Merchant Energy.

Everything that we are going to be talking about and showing is public material. You'll see as we go through the slides, some of the exhibits have the words, "protected material" on them. In those cases, that material was made public at the hearings at the FERC. So, nothing in this packet is privileged material, and nothing that we will be speaking to is privileged.

CHAIRMAN DUNN: If we do tread upon that territory, Paul, obviously just say so and we will try to respect the limitations you're under.

MR. CARPENTER: Thank you.

And as I said, this is the result of nearly two years of research, and hearings, and testimony on our part. And I think for anybody to get a grasp on what happened in the

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California gas market during the 2000-2001 energy crisis, you basically have to understand what happened on the El Paso system. So, that is primarily we're going to try to accomplish in our presentation. Then we're happy to answer questions on anything.

The way we've done this is, we've divided it up into about four parts. I thought we would start, sort of to ease us into the subject, with some discussion of terminology, some discussion of basic facts about the market, and some of the history of the market so that everybody's on the same footing.

Then we're going to turn to the conduct of El Paso Merchant Energy, as the holder of a very large portion of the El Paso pipeline under contract during the 2000-2001 period. We're going to look at their conduct; we're going to look at the documents that were uncovered in our research as to their intent to withhold capacity from the market to raise price.

CHAIRMAN DUNN: Let me interrupt for one second.

Just for clarification, because I know some have not been intimately in the natural gas side, in essence, we're dealing with El Paso as the owner of the pipeline. Specifically you're going to focus in on El Paso Merchant Energy, a separate corporate entity, I believe, as a subsidiary of El Paso.

MR. CARPENTER: That's correct, an unregulated subsidiary. And we'll take you through how that contract was formed.

Then, after we discuss El Paso Merchant Energy, we're going to turn to the pipeline's conduct itself. As you may know, in the FERC proceeding, the complaint proceeding, the

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initial phase of the proceeding, that we sometimes call Phase I, focused on Merchant Energy's conduct.

Then, when it became clear, when further evidence came out as to what was happening on the pipeline, and the pipeline's defenses to the charges that Merchant was withholding, some facts about what the pipeline was doing with its capacity became clear, and that was the subject of another phase in the proceeding that's sometimes called Phase III, just to be confusing.

Then, after discussing El Paso Natural Gas's conduct, then we're going to turn some calculations that we've made of the effect of this on California, and the profits that were earned as a result.

So with that, turning to some basic facts that most you may be familiar with, but I'll just quickly go through some of these things.

CHAIRMAN DUNN: I'm going to interrupt again, Paul.

These are on the handouts, I believe; correct?

MR. CARPENTER: They should be, yes.

CHAIRMAN DUNN: If folks don't have them, just raise your hand. Ronda and Alex, instead of having folks come forward, why don't we just hand them out so everybody has them.

Go ahead.

MR. CARPENTER: This is a map of the natural gas infrastructure that serves California. California's essentially served from four major supply basins: from Canada, the Rocky Mountains, what's called the San Juan Basin in the Four Corners

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area, and the Permian Basin in Texas. Those basins are connected to California via interstate pipelines, the major pipelines being: PG&E's Gas Transmission Northwest pipeline from Canada that intersects the state's border at Malin; the Kern River pipeline which runs from the Rocky Mountain Basin past the Las Vegas area and into the Bakersfield area, where it connects with the Mojave pipeline; and then the two pipelines that serve from the southwest basins, the San Juan and Permian Basins are the Transwestern pipeline and the El Paso Natural Gas system.

Just in terms of total capacity on these pipelines, there's roughly 7 billion cubic feet per day of capacity into the state. That is split roughly 2 Bcf on the PGT system; 3.3 Bcf on El Paso, 1.1 Bcf per day on Transwestern, and about .7 Bcf per day on Kern River.

CHAIRMAN DUNN: I'm sorry, Paul. Can you go through those numbers again?

MR. CARPENTER: Yes. Roughly 2 Bcf per day, that's billion cubic feet per day, on the PGT system from Canada; .7 Bcf per day on the Kern River system; 1.1 Bcf per day roughly on the Transwestern system; and roughly 3.3 Bcf per day on the El Paso system.

CHAIRMAN DUNN: Thus, El Paso being the largest.

MR. CARPENTER: El Paso is the largest.

The other important thing to recognize about this market is that the gas from Canada and from the Rocky Mountain Basin has historically been very cheap relative to gas from the

Southwest basins. What that means is that those pipelines from

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the Rockies and from Canada have been base loaded. They're running full all the time. That has also been the case on the Transwestern pipeline from the San Juan Basin, which I'll describe in more detail later.

What has happened is that that has left El Paso as the swing pipeline to serve the needs of the state. So, when demand increases for natural gas, El Paso is the pipeline that had and has the spare capacity. It's important to the economics of the situation because what it means is that the Southern California border, where the El Paso and Transwestern pipelines intersect the state and enter the local utility system, those border points become extremely important in determining the price of natural gas that's paid by everybody in the state. They have become, and have for the last ten years, essentially, been the reference points for natural gas prices in California.

So, El Paso is the swing pipeline. El Paso's capacity is critical for meeting demands in California. And therefore, as you will see in the evidence that we'll show, its ability to withhold capacity from the market has had a direct impact and ability to raise price.

Just by way of a couple other comments, there is local production in California. About 10 to 20 percent of California's needs are met with gas that's produced right out here in the Sacramento Delta to some extent, and then there's some down in the oil fields area around Bakersfield. So, there is some gas in California. That gas has been depleting over time. It's not a major source of future potential, but it does exist.

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The other thing I want to mention, because we'll be talking about it to some extent, is the concept on the El Paso system of the East of California market, sometimes called the EOC market. That is everything east of the California border, includes the major areas of Phoenix among others. And as you'll see, that has been an important source of growth and demand on the El Paso system in a way that has impacted its ability to serve California, which we'll go into in some detail.

Turning now to just some basic terminology, and I'll go quickly through this. When we refer to prices, we talk about units of one million Btus, British thermal units. Prices are reported in dollars per million Btus. That's the unit that you see.

CHAIRMAN DUNN: I think we need for the slide purposes, I think we're missing just a little bit to the left-hand margin. If we can slide the projector just a tad.

MR. CARPENTER: When we refer to prices, there's two kinds of transactions that are typically referred to. One is called a bidweek price. That is price for month-long supply that's provided in equal daily amounts. You contract for it on essentially the week prior to the first day of the month for flow the next month. Sometimes that's called a base load contract.

We also talk about daily prices. That's the price of gas that you buy on the daily spot market. That is sometimes referred to as the swing market for natural gas.

And then we will refer also the Henry Hub, which

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is on the previous page's map, it's indicated. It's in Louisiana, a very active trading location for gas. The New York Mercantile Exchange offers a futures contract there. It is the, essentially, the national reference point for gas prices.

When we talk about El Paso, we've all ready said there's two entities we're going to be focusing on, El Paso Natural Gas, which is the regulated pipeline, and El Paso Merchant Energy, the unregulated marketing affiliate.

When we talk about capacity, we refer to units of volume. And here we're talking about cubic feet, thousands of cubic feet. One million Btus is essentially 1,000 cubic feet of gas in conversion. And you will see us refer to units of one billion cubic feet of gas.

Just to give you a feeling, 100 million cubic feet per day of gas is about what a 400 megawatt power plant uses. The San Diego system in 2001 used an average of 388 million cubic feet a day of gas, and California in 2001, on average, used about 6.7 Bcf a day of gas in the entire state. That is to give you a rough feeling.

The other concept that we're going to talk about is the concept of a basis differential. Sometimes you'll hear this referred to as a basis spread in the traders' lingo, or just a plain spread. But the basis differential essentially reflects the implied value of transporting gas from a producing basin to California.

And we've used an example on the slide on Page 4 that calculates the basis differential based on the bidweek prices for December of 2000, which, as you remember, was a very

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high priced month. During that month, the California border price bidweek price was $14.45. The Permian Basin price was $6.26. The difference between those is the basis differential of $8.19. In this particular month, that value was extremely high. And when you compare it to what the actual regulated tariff is on the pipeline from the Permian Basin to California for that month of 69 cents, you can see how out of whack the market was.

Now, as Matt points out, since the transportation value in this case is 69 cents as a cost-based regulated tariff, the difference between the $8.19 and the 69 cents is essentially a profit, pure profit, for anybody that holds the capacity and is paying the regulated tariff rate to the pipeline.

CHAIRMAN DUNN: In other words, whoever owned that capacity and paid the regulated tariff on this example of December made a heck of a lot of money.

MR. CARPENTER: Absolutely.

To see historically how the year 2000-2001 differed from prior experience, what we've done on this chart on Page 5 is plot the California border price in the dotted line, as compared to the price at Henry Hub in Louisiana, which I mentioned earlier was a reference price.

As you can see, prior to April of 2000, those prices moved basically in lock step. In other words, California was not penalized in a sense for being far away from the Gulf Coast. You essentially paid the price at the border that somebody buying gas in Louisiana would pay, and in part, that was because you have access to very cheap supplies in Canada and

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the Rocky Mountains.

But what happened in the year 2000 was, the California border price went out of control essentially. And this is a depiction of the monthly price, which shows it peaking on monthly bidweek basis at around $16 in December of 2000.

We've shaded in yellow here the period of time in which El Paso Merchant Energy held 1.3 Bcf of capacity on the El Paso system. We're going to be talking about that contract and El Paso's behavior in using that capacity during that time period. But it's our view that the evidence demonstrates that their withholding of capacity from the market was largely responsible for this differential.

CHAIRMAN DUNN: Senator Johannessen.
SENATOR JOHANNESSEN: Thank you, Mr. Chairman.
I didn't quite follow the sequence. You say there was plenty of gas available.
MR. CARPENTER: In the producing basins, yes.
SENATOR JOHANNESSEN: And are you saying that the demand in California was exceeding the supply?
MR. CARPENTER: As we'll discuss in a bit, demand in California did increase during the summer of 2000. It put -- it started to put pressure on the interstate pipelines serving California. At the same time, El Paso's unregulated marketing affiliate, that held 35 percent of the capacity on the El Paso line, chose not to nominate and deliver gas using their capacity.
SENATOR JOHANNESSEN: So, the subsidiary of El Paso Gas held the contract for that gas. And they then chose to
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withhold that capacity so the lines were not full coming into California.
MR. CARPENTER: The El Paso line was not as fully utilized as it would have been had they nominated all of their supplies. You'll see that in some exhibits coming up.
SENATOR JOHANNESSEN: So, in saying that, you are separating the two companies, even though they're one. You're separating the two companies so any blame would go on the other one, the unregulated one.
MR. CARPENTER: Yes.
SENATOR JOHANNESSEN: Obviously, then.
I just want to get the picture of what you're trying to tell me.
MR. CARPENTER: Yes, and thanks for the question because it is -- we're going to be talking about the conduct of the unregulated marketing affiliate --
CHAIRMAN DUNN: That's Merchant.
MR. CARPENTER: That's Merchant, and then we're also going to talk about the conduct of the pipeline itself.
CHAIRMAN DUNN: That's El Paso.
MR. CARPENTER: That's El Paso.
CHAIRMAN DUNN: Go ahead.
MR. CARPENTER: Turning to Page 6, what we've done here is a slightly different depiction of what happened during this time period. Here we're looking at basis differentials. We're looking at this implied transportation value. Again, this is monthly data, and we're comparing it to a basis differential in another market, in this case Chicago.
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Look at what happened in Chicago over this time period compared to what happened at the California border. You can see that generally speaking, up until about April of 2000, again, the implied value of transportation is relatively low on pipelines. On the El Paso system it was about 27 cents from the San Juan Basin to the California border prior to the Merchant contract. The Henry Hub-Chicago basis was about 11 cents. That's been pretty typical of the history.
During the time period when El Paso held the contract, the average differential rose to about 10 times on average. Again, these are monthly prices, not daily. We'll see the daily effect in a minute. But even the monthly price had a 10-fold, or greater than 10-fold increase, to about $3.78 relative to what happened in the Chicago market of slightly more but still about 18 cents.
CHAIRMAN DUNN: Again, the shaded area is the Merchant contract.
MR. CARPENTER: Is the time period of the Merchant contract.

After the Merchant contract expired and the capacity was divided up amongst about 30 other capacity holders, the price settled down at the California border very quickly.

MR. DRIVON: You just indicated to us that following the period of time that Merchant owned this pipeline capacity, which I believe was actually about 39.3 percent of the capacity, if I'm correct, the capacity was split between about 30 entities.

Prior to the time that Merchant put this

contract, how was that capacity divided?

MR. CARPENTER: Excellent lead-in question to the next two slides.

CHAIRMAN DUNN: That was not rehearsed, in case anybody wants to know.

MR. CARPENTER: Yes, you're right. There was a series of contracts.

It's very important to understand how this came about, because it's our view that El Paso learned from the behavior of prior holders of capacity what could be done with this pivotal or swing capacity into California.

CHAIRMAN DUNN: When you just said, "El Paso learned," you're referring to Merchant or El Paso?

MR. CARPENTER: I'm referring to the El Paso Corporation which includes both the pipeline and the unregulated affiliate.

CHAIRMAN DUNN: Got it. I just wanted to make certain.

MR. CARPENTER: So, what we've done is list a few key event leading to the Merchant Energy Natural Gas contract.

If you go back to the early 1990s, in the late '80s, California ran into constraints with respect to its gas market, and there was a lot of concern that there was not enough infrastructure to deliver interstate gas supplies into the state. And so, the CPUC went through a process, as did the FERC, to try to encourage new pipeline capacity. And there were a series of competing projects to build new pipelines.

That process led to the development of the Kern

River pipeline, that I mentioned earlier. It led to a substantial expansion of the PGT pipeline. Those pipelines, obviously, made a lot of sense because, again, they were coming from the very cheap supply basins. They got immediate, 100 percent contractual subscription when the lines were built. Went into service, and almost immediately, they started running at full through-put.

What that did was, it to some extent unloaded the El Paso system. It created an excess capacity on the El Paso system of about 2 billion cubic feet per day. That's a lot of excess capacity.

MR. DRIVON: That's about a third of the total needs of California was then created as excess.

MR. CARPENTER: That's correct.

MR. DRIVON: That should be enough excess capacity to allow the population and the economy of California to expand by a third before we got back into the pinch that we had been in prior to this expansion project.

MR. CARPENTER: I think that was the view in the early '90s, is that this would be a capacity glut that would continue. El Paso, to some extent, felt victimized by this, that these new pipelines were built and their system was the one that was going to be stranded.

In fact they -- the customers on the El Paso system turned back physical capacity when their contracts expired, literally turned it back to the pipeline.

MR. DRIVON: That was PG&E, for instance.

MR. CARPENTER: PG&E for instance, yes. Southern

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California Gas as well to some extent turned back capacity and others.

That led to a series of negotiations between El Paso and its customers. That resulted in a settlement in 1996. And as a result of that settlement, the customers and El Paso agreed for a 10-year time period that they would share the stranded costs, if you will, associated with this excess capacity, of the financial burden of that.

At the same time, customers -- the California customers were forward looking in the sense that they realized that this is a lot, 10 years is a long time for any settlement. We need to be sure that if the system starts to tighten up again, that El Paso has an incentive to increase its facilities to meet California's needs. So, there was a clause in the settlement which said that El Paso agreed to maintain its facilities and operate them sufficient to meet its obligations. And its contractual obligation to California was about 3.3 billion cubic feet per day.

Then, starting in about 1998, and perhaps a little bit earlier, El Paso began to aggressively market their capacity, their excess capacity, to customers east of California. Matt's going to talk about that later on, because it's that aggressive marketing, while at the same time not maintaining their ability to deliver to California, that is in part what produced the results that happened in 2000-2001.

So now --

CHAIRMAN DUNN: Senator Johannessen.

SENATOR JOHANNESSEN: Not being an attorney, I'm

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trying to follow the sequence.

I have to ask, one, if you're familiar with a meeting that happened the 23rd and 24th in Phoenix, Arizona about a month after we passed de-regulation in California? Are you familiar with that meeting?

MR. CARPENTER: I'm familiar with the documents that have been attached to some of the private plaintiffs lawsuits concerning that meeting and their allegations, yes.

SENATOR JOHANNESSEN: And when you're talking about the pipeline capacity, my understanding, at least alleged, is that the pipeline was not built, and a deal was struck not to build that additional pipeline capacity. In fact, I guess El Paso Gas bought off, if you will, the proponents of this particular pipeline.

If I hear your testimony, you continue to basically say that capacity was not the issue. The delivery of the gas was the issue, and issue was that some that held the contract did not deliver this gas.

Are you also familiar with a letter that was sent by PG&E to the Governor of California that basically said we have plenty of gas; we can't afford to buy it? Are you familiar with that letter?

MR. CARPENTER: Not with the letter, but I'm familiar with PG's&E situation at the time.

SENATOR JOHANNESSEN: And so, I'm trying to get in mind, it seems to me that the push for de-regulation were the same people who then shortly thereafter met in Arizona to basically plot the plan by which to take advantage of what's

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going to happen in California.

I just want you to know my mind-set when I'm listening to you. Please explain to me who basically was the roadblock in this, and to what extent Merchant or El Paso Gas

was a party to it, and what led up to their decision to do what they did?
MR. CARPENTER: Yes. Our focus today is primarily on the behavior of El Paso. We have not been privy to materials which would -- or discovery which would fully elucidate what happened at the meetings that you discussed, but we are aware of the allegations.
The pipeline that you're talking about, that the allegation is that this agreement prevented from being built was actually the expansion of the Kern River pipeline. And again, that's an allegation. If it were true, it would be consistent with El Paso's incentives, which we'll talk about in a bit here.
SENATOR JOHANNESSEN: Are you referring then to the pipeline that was to connect the northern section and the southern section?
MR. CARPENTER: Yes, there was --
SENATOR JOHANNESSEN: The deal was basically struck, alleged deal was struck that the northern section would then be under the control and use of PG&E, and Southern Cal Edison and El Paso Gas would then have the southern portion, and that the pipeline would go between the two, which would then distribute this inexpensive gas from the north, perhaps, was the deal made at that. The consortium, which worked to build this pipeline, did in fact not do so after the agreement was made.
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MR. CARPENTER: Yes, that is the allegation, and it's referring to what was called the Altima Project from Canada to the Rocky Mountains, which was going to connect up with an expansion of the Kern River pipeline into Southern California.
Again, we're -- we're not in a position really to be able to assess the merits of that evidence, but we're certainly aware of the -- aware of the allegation.
CHAIRMAN DUNN: Paul, before you continue, the Committee would like to welcome Senator Gloria Romero who's joined us for the hearing as well.
Please continue.
MR. CARPENTER: So, a question was asked about who held the capacity prior to Merchant's contract.
If you turn to the date of January 1998, again, this is subsequent to the settlement with their customers, El Paso essentially took that large block of capacity on its system and sold it to one party. And they sold it to Dynegy in January of 1998.
At the time, Matt and I were providing some advice to Southern California Edison, who had a lot of interest in what was going on on the El Paso system because they held some capacity, and they also were active in the electricity market. We looked at that contract and became very concerned that it had elements in it that were anti-competitive.
For example, there was an agreement -- there was a feature of that Dynegy contract that was called a reservation charge reduction mechanism that said that if El Paso was to provide interruptable transportation in competition with Dynegy,
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as the holder of that capacity, that there would be a dollar-for-dollar reduction to Dynegy in the demand charge that they would pay to El Paso for interruptable transportation above some fairly low threshold of volume.
We viewed that as an agreement not to compete, just plain on its face. Edison filed a complaint at the FERC at the time that contract was entered into. And then, we watched as Dynegy idled a substantial amount of that capacity and was successful in raising price, by our calculation, about ten cents per MMBtu, or about a 5 percent price increase greater than what the price would have been if they had elected to use all of

their capacity.

It seemed like a big number at the time, but it paled in comparison to what happened subsequently. But what we learned from that experience was that the holder of that capacity, even though there was excess to the market, that that was a big enough chunk of capacity that you could move prices by keeping it off the market, by withholding it, particularly if El Paso agreed, as they did during this time, essentially not to provide any interruptable transportation in competition with it.

What happened was, during this period there was a dramatic through-put shift that happened almost immediately to the Transwestern system, so everybody jumped over to the last remaining pipe that wasn't completely full into California, and that left El Paso as the swing pipeline.

MR. DRIVON: Excuse me. This 1998 contract for 1.3 billion cubic feet with Dynegy, do you have information as

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to whether that was likely an arm's length transaction between El Paso and Dynegy?

MR. CARPENTER: Put it this way. We don't have -- we were never able to get discovery in that complaint case. It was never set for hearing. We were never able to determine exactly the circumstances under which that contract was entered into.

It was what's referred to in the trade, I think Matt can correct me, as a prearranged deal.

MR. O'LOUGHLIN: That's correct.

MR. DRIVON: Prearranged means cooked up?

MR. CARPENTER: Well, it just means it's a two-party; it's a bilateral contract, and it was under special terms. It wasn't under a pro forma kind of regulated standard contract. But it had to be submitted for approval.

It was protested, but what the FERC found was that, I think quite interestingly, they found that the -- they were quite concerned about this reservation charge reduction mechanism as well. And they found it to be anti-competitive, but they let it go forward, and they let the contract go forward on the grounds that there was so much excess capacity into the state, that this 1.3 bcf a day wouldn't matter. That's essentially what their finding was.

MR. DRIVON: So, the FERC found that the mechanism was anti-competitive, but the so-called excess capacity, which turned out later to be phantom excess capacity, excess at the whim of the contract parties in this case, would be sufficient to eliminate the potential for the exercise of

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market power in the delivery of gas to the California border; right?

MR. CARPENTER: Right. And remember what happened subsequent to '98 that we'll discuss is, the demand for natural gas increased substantially in California in 2000-2001, and also in East of California. So, the El Paso system started to tighten up.

And if there was any doubt in 1998 as to whether or not the Dynegy capacity was pivotal to the market, there was absolutely no doubt, in our view, that in 2000, the El Paso Merchant capacity, subsequent holders of it, became pivotal to the market.

MR. DRIVON: So once again, the ability to make this work depended on the inability of the FERC to understand the potential for the exercise of market power, similar to their failure to understand that relationship when they allowed the division of the electric generating capacity in California.

MR. CARPENTER: I'll put it this way, if they had followed our suggestion to essentially break up that contract as it is now into multiple holders of capacity to create competition, our view is that a lot -- that the gas problem that happened in the California energy crisis either would not have occurred at all, or would have been substantially mitigated.

MR. DRIVON: Which is a fancy way of saying, they missed, just like they did in electricity.

MR. CARPENTER: They missed in this one, that's for sure.

Dynegy held the contract for two years. In

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January of 2000, El Paso again was trying to -- was recontracting its capacity, and they entered into a one-year deal with Enron for 1.2 bcf a day of capacity. This contract was a little bit different than the Dynegy contract. Instead of having this reservation charge reduction mechanism in it, it had a revenue sharing formula between Enron and Merchant Energy.

If you'd flip to the next page, we've got a little graphic that describes how this worked. You can see in the bar on the left, we describe how the California border price gets built up. You got the price in the Basin down at the bottom. You add the fuel charge to run the compressors on the pipeline, and then there are variable transportation charges that the pipeline charges.

On top of that in blue is essentially the value of the capacity itself. So, it's the additional value relative to a cost-based, variable cost-base component that gets you to the border price. Essentially, Enron and El Paso Merchant agreed to share 75-25 any increase in the value of the capacity over time, over this one-year period.

Going back to the previous page again, Edison was getting ready to protest this contract as well.

CHAIRMAN DUNN: Let me interrupt.

For those who are following, the profit sharing contract that Paul has just referred to is something, I believe, Paul, that you and Matt are familiar with. I think you have seen it through your own work.

It's also something that, through the discovery procedures, this Committee has come across as well, too,

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reflecting exactly the figures that you're referring to, Paul.

MR. CARPENTER: Yeah, and this is a public contract because it, again, was submitted to the FERC for approval.

It had another feature which the previous, the Dynegy contract, did not have, in that it gave Enron priority rights to the SoCal Topack delivery point for all of the capacity. That's something that was valuable.

What the FERC did was, they accepted the contract, but they modified those delivery point rights to not be as favorable as the parties had negotiated them. When that happened, Enron decided to terminate the contract. So, no gas ever flowed under this contract.

Just to continue the chronology here --

MR. O'LOUGHLIN: Before you do that, Paul, just one thing to bring home with the chart and this event is, the notion here was to the extent one could expand the basis differential between California and the Basin, these two companies, Enron and El Paso, would share in the benefit of that basis differential expanding. So, it just goes back to the map that we showed earlier. The higher the prices were at the California border relative to the producing Basins, the more valuable the contract would be to both parties.

MR. DRIVON: In other words, to make it simple, the more you could jack-up the price at California, the more money both of them made.

MR. O'LOUGHLIN: Yes.

MR. CARPENTER: Right. They agreed -- they agreed

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to share in the proceeds. Again, that contract -- Enron backed out of that contract.

Simultaneously with this process occurring in the beginning of 2000, El Paso the pipeline announced that it was going to purchase the All America crude oil pipeline. All America was a pipeline that ran from the Bakersfield area to Texas, essentially, and shipped oil, crude oil. El Paso announced that they were going to purchase it, and they got it pretty much on the cheap, and that they were going to convert it to a gas facility and integrate it into their system. Again, this is February, 2000.

These dates will become important later based on what they knew at the time.

MR. O'LOUGHLIN: Let me just add one more thing.

Again, there was a steady drum beat from 1996 forward to 1998 to 2000 about the excess capacity, and the fact that there was excess capacity on the El Paso system. And that was the reason why there was no need to worry about any exercise of market power, because of the fact that there was substantial excess capacity.

So, on the one hand, you've got El Paso saying, not to worry, there's plenty of excess capacity on the system, and yet you start to see events that contradict that, awarding these contracts in large blocks, and the sharing arrangements for the revenues, the purchase of a pipeline to convert it for capacity while at the same time supposedly there was excess capacity on the system.

So, there's inconsistencies that start to crop up

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as you look at events.

MR. CARPENTER: Right.

And subsequent to that, in March 1 of 2000, El Paso entered into the 15-month contract with its affiliate, Merchant Energy. Really the -- when they put it out for bid, essentially they said you had to get -- you had to purchase all of it or none of it, even though they had many, many bids from other parties for pieces of it. So, in our view they essentially set up the bidding such that their own affiliate would come out victorious.

This series of events explains why the CPUC, in April of -- the beginning of April of 2000 was in a position to file the complaint that it did at the FERC even before the energy crisis really hit in California.

And that's one thing that I think is quite unique about this case. This isn't a case of the CPUC or the California parties reacting after the fact, after seeing the price effects. They're reacting before the fact because we had seen what had happened with the Dynegy contract, we'd been worried about the Enron arrangement. Complaints had been filed at the FERC previously to that. We'd seen that this capacity was pivotal in the sense that it could be used to raise price.

And so, the CPUC filed its compliant as a prophilactic measure, if you will, before the events occurred, and it's a great credit to CPUC that they did that.

Now, we're still litigating the case. It's now two years, almost two years, since that date.

CHAIRMAN DUNN: Paul, let me interrupt for just a

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question on Merchant and the 15-month contract.

In your view, was Merchant financially prepared to bid on such a large amount of capacity?

MR. CARPENTER: Sure. I mean, it's an inter-affiliate deal. I mean, they bid $38 million for the capacity. Essentially, it's a payment to your parent, so it's not -- it's not from a corporate cash point of view.

Now, what they still had, however, was the corporation had the risk that that capacity wouldn't be worth $38 million if the basis differentials didn't widen or stayed small. That was the risk that they took.

But they knew at this time that they would be in a position to widen basis differential by manipulating and withholding that capacity from the market.

And to see that, we'll turn to some documents.

CHAIRMAN DUNN: Let me rephrase it just a little bit.

So, Merchant's ability to bid on such a large amount of capacity, is it fair to say, was dependent upon its relationship with El Paso?

MR. CARPENTER: We think so.

MR. DRIVON: Was it also dependent on Merchant's ability to use either complete or partial release of that capacity to a third party? In other words, they now had the capacity; they had to use it some how.

MR. CARPENTER: Or not use it if the effect of not using it would be to raise the differential and make --

MR. DRIVON: Sure, that would be a way to use it,

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would be to not use it.

So, they were going to need another party involved in this thing to take them out of the back end of this risk; right?

MR. CARPENTER: Well, certainly, and what you'll see, they viewed it as being attractive to hedge some of this capacity going forward. They didn't do it all, but they hedged some of it.

MR. DRIVON: Right. In other words, they needed somebody on the other side of this thing to make it work, or at least make it work better. And I suspect in a little while you're going to tell us who that might have been.

MR. CARPENTER: Yes, we'll get to that.

CHAIRMAN DUNN: A foundational problem I have, Paul. Apologies for continuing to interrupt.

For those who are unfamiliar, when you say they hedged it, can you define that in lay terms, what you mean by that?

MR. CARPENTER: Yes.

Essentially a transportation contract on a pipeline is, you're holding a physical -- you're holding rights to a physical asset in which you've committed to pay monthly payments forward into the future. So, it's like holding a forward, long-term contract.

The value of that contract depends on the basis differential. The basis differential falls; that contract falls in value. The basis differential rises, that contract rises in value.

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A hedge would be -- and there's a lot of volatility in these markets, no doubt about that. So, parties with this kind of exposure, forward exposure, will seek to hedge some of that exposure with another party who will agree to, essentially, through a financial contract, take the opposite position. And that can be done with a variety of mechanisms: swaps; you could do a short sale at border combined with a long sale at the basin.

But there were parties that were in the business of providing these kinds of hedge transactions, and Enron in particular was one that would provide it. But a whole host of parties would -- would be willing to enter and take the opposite side if they believed that something different might be happening to the basis differential.

We've put a document up on the screen. It says "Protected Materials." Again, this was -- this is a redacted version of a presentation, and the portion that we're showing was made public at the FERC hearing.

This has been variously referred to as the "Valentine's Day Presentation," February 14th, 2000. This was a presentation that was made by El Paso Merchant Energy to Bill Wise, who is the CEO of El Paso Corporation.

And as was revealed ultimately in testimony before the FERC's ALJ, Administrative Law Judge, essentially they were seeking the Corporation's approval for entering into this contract with the pipeline. And this, among a couple of other documents, is sort of the underlying basis for the ALJ's original finding in his first initial decision that this

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contract was an agreement amongst affiliates that violated the FERC's affiliate regulations.

It's clear that the regulatory requirement that parties -- that affiliates, unregulated and regulated, operate at arm's length, was essentially violated in this circumstance. It was clear that Bill Wise, as Chairman of the Corporation, was, and as he ultimately had to agree, was making decisions concerning whether or not the unregulated affiliate would enter into this contract.

A couple of things to note in this presentation. In the page called, "Strategic Advantages," you note the very first bullet is their reference to their ability to have more control of the total physical market.

And the initials "SC" refers to Southern California; "SJ" is the San Juan Basin; "Perm" is the Permian Basin, et cetera.

I think the third bullet is also interesting:

> "Ability to influence the physical market to the benefit of any financial hedge/position."

That's the beauty in these kinds of markets, that you have market power that allows you to control physical capacity, and you have the ability to move price, you can profit tremendously by -- with that knowledge by taking financial positions. But the source of the market power is still the control of the physical capacity.

The fifth bullet, I think, is interesting:

> "Greater influence on intra-month

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> spreads."

Again, spread is another reference to these differentials that we're talking about.

Under "Challenges" on the next page, the very first one, again, reiterates the notion that there's this excess capacity, and that El Paso and Transwestern were acting as the swing supply pipes.

And you'll note also in the fourth bullet, and this may get to the question that you were asking earlier,

> "Don't know if there is sufficient financial liquidity to either hedge transport or to justify idling large blocks of transport."

So, here they're acknowledging that their choice of minimizing the risk if the market power exercise actually isn't successful in either hedging some of it depends on there being liquidity in the financial market to hedge it, or that they can successfully idle large blocks of capacity and minimize their risk in that fashion by raising price.

CHAIRMAN DUNN: And again, Paul, this is a presentation by Merchant to the parent, El Paso?

MR. CARPENTER: Yes.

Then about a month or two months later, again, this is a redacted memorandum. It's actually minutes from a Board of Directors meeting from Greg Jenkins, who was the head at that time of Merchant, Merchant Energy, to Bill Wise, the CEO of the Corporation. So, this is after they had held the

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capacity now for about two months.

And on the next page, the only portion that was made public, that we were allowed to see, is this section on the "El Paso Capacity." This is the famous intent sentence that the judge refers to,

"We will make money two ways:
1) increase the load factor,
2) widen the basis spread."

So, it's clear that Merchant is communicating to the Corporation that says, we have market power; we can move price by our ability to manipulate this capacity.

So, you will recall earlier that we looked at some charts that showed monthly prices, and I said at some point we'd talk about daily prices. Just to give you a feeling, I think the statistics we've seen indicate that about half of the volume of transactions at the California border were being done during this period on a daily basis, and about half on a monthly basis. So, this is a significant part of the contract.

What I've done here is, I plotted a few different things on this chart to kind of give you a feel for the timing of certain events and their relationship to the underlying cost of transportation.

The very first thing I've done here is, I've drawn in the variable cost to transport, which is the blue line at the very bottom. That's the -- that's the per unit cost to transport on The El Paso system if you held capacity.

CHAIRMAN DUNN: I'm sorry, Paul, to interrupt.

Are you going to be overlaying these? We're

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looking at what appears to have all of them at one time.

MR. CARPENTER: Right. I'm going to go one at a time here.

CHAIRMAN DUNN: That's okay. We just want to make sure we're on track with you.

MR. CARPENTER: Yep. There's a lot going on, so it's a little confusing, and so I thought I'd lay them in.

This variable cost is the measure by which El Paso, and any rational holder of capacity --

CHAIRMAN DUNN: I'm going to interrupt again.

For those who are following it, we're on that very next slide after the several page memo that most of it was redacted, other than that one paragraph that he has referred to. The next page is entitled, "SoCal-Permian Basin Basis Differential vs. Variable Cost of Shipping on EPNG."

There's many different lines here. What we see here is just one line. It's at the very bottom, entitled "Variable Cost."

Again, Paul, what you're going to be doing is overlaying the rest of these lines on top of it.

MR. CARPENTER: That's right.

CHAIRMAN DUNN: Okay.

MR. CARPENTER: And the variable cost measure is sort of the benchmark in terms of deciding whether or not it's economic to sell another unit of gas or to move another unit of the gas on the pipeline.

So, if the price as reflected in the basis differential is above that variable cost line, it made sense to

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try to move as much as gas as you possibly could if you are acting competitively and economically.

So, you can see if you start out -- I've plotted in the two lines at the left that show the bounds of the time period of the contract, starting in March 1 of 2000, expiring May 31 of 2001.

And the first thing I've done is to show what has happened -- what happens to the SoCal-Permian basis differential in the summer of -- in the spring and summer of 2000. Later I will show you what they're doing with their nominations and utilization.

But for the moment, recognize that it became economic to try to move as much as gas as you possibly could into California at least by late May and June of 2000. The red line is -- sort of parallels the variable cost line up to that point, and then you start to see the differential increase.

We believe this was a very critical time for California. These numbers on this scale don't look that big, but by historical standards, these are huge increases in the basis differential. Remember, we talked about 10 cents from Dynegy that was enough for the Edison complaint. Here we're talking about 30, 40, 50 cents spreads. And so, from a historical standards, we were saying, what is going on here? You know, this is unprecedented.

CHAIRMAN DUNN: You're only referring, because I know the rest of the audience can't see, the only thing he put up there as far as SoCal-Permian Basin line goes up to about August. Right now that line ends, and we're not even to August

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yet. That's the time period you're referring with the 30, 40, port 50 cents.

MR. CARPENTER: Yes.

Another important thing -- and it's clear that during the summer of 2000, at the beginning of the California electricity crisis, the demand for natural gas was rising substantially. So, there was -- there was significant demand for increased supplies.

The price was reflecting that. And what we'll be asking ourselves later is, what was Merchant doing? Were they nominating all their capacity, or were they keeping capacity off the market?

But the other critical thing that happened during this period was that instead of storage getting filled in Southern California, which traditionally would happen during the summer time period to have enough gas in storage for the winter, these prices were causing parties making their decisions about whether to build their inventories to decide not to build their inventories. Prices were going up in the summer, and they were -- they were looking out into the future and saying, why should I put gas in storage now when it might be lower in the winter? That makes no economic sense.

So, everybody else on the El Paso system was selling as much as gas as they could on the border. Price was still going up.

But the key thing is, El Paso Merchant was not nominating all of their capacity during this period, even though there was capacity available. Okay?

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Now, the next event I'm going to put up is a vertical line, and that's on August 19th, 2000, the El Paso pipeline exploded in New Mexico at a place called Carlsbad. Very serious incident, killed about eleven people. And it immediately took about 500 million a day out of their system.

And the reason I take a break at that point is because frequently now you hear El Paso talk about the Carlsbad explosion as being the reason why they couldn't meet California demand.

The fact of the matter was that for the four months during the summer time period prior -- three months prior to that, had nothing to do with the explosion. The pipeline, Merchant Energy wasn't nominating and utilizing all of their capacity, even though it was economic to do so.

So now we have the explosion, and now I'm going to show you what happens to price on the daily market after this point. Initially, there's an impact on price from the explosion. Then, once that capacity starts coming back on line, prices calm down until about November of 2000, when it goes out of control.

Now this graph is perhaps somewhat misleading because in order to get the scale on the graphs so you can see what's going on, I've had to clip the top of these peaks. In fact, the December 2000 peak was so high that I would have to build -- this chart would have to be four times higher than it is now to fully depict the peak in the price.

MR. DRIVON: More to the ceiling. Clear past the ceiling.

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MR. CARPENTER: Right. The price peaked on -- at $48.91, I think it was like December 16th or thereabouts, and this chart only goes to $11. It's almost difficult to graph what's happening here and still be able to relate it to the history of gas at the California border.

There were essentially three significant peak episodes: one that occurred in February of 2001; again occurred in March of 2001.

The other thing I would focus on because we'll talk about it subsequently is, you'll see the price backed back down at essentially the first week in January of 2001. It didn't go all the way down to variable cost, but it dropped somewhat. And you'll see later that that corresponds with a period in which Merchant Energy again tries to withhold gas from the market to see if they can prop the price up.

But once the price reached these stratispheric levels, essentially Merchant was, at that point, moving as much gas as they -- nominating as much as gas as they could because it was tremendously profitable to do so.

CHAIRMAN DUNN: Let me restate that, Paul. What you said is, once the price went up to these peak points, Merchant moved as much as it could.

MR. CARPENTER: Yes, and you'll see that in a minute.

CHAIRMAN DUNN: Surprise.

MR. CARPENTER: Now, part of what's going on here, of course, is the fact that as of November 2000, in our view, because of what had occurred in the summer of 2000,

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storage inventories were low, particularly in Southern California, going into the winter. And so, to some extent what's going on here is that the increase in demand in the winter time, which was high but not atypically high for Southern California winter, started to put increasing pressure on the physical capability of the interstate system to meet that demand.

We'll talk later about whether or not El Paso the pipeline during this period made all of its capacity available to the market, and we'll see evidence that they in fact did not, which is the Chief Judge's most recent finding in the FERC case.

And just to carry the story through, we have the expiration of the contracts. What happened to the price the week or two weeks after the contract expired. Immediately it damps down, and by August of 2001, we were back in the historical pattern.

CHAIRMAN DUNN: For everybody's sake, what Paul just added was the remaining lines to the right of the May 31st, 2000 expiration of the contract.

I just want to note, I suspect you're aware of this, it's been one of our concerns for a long time that each of those spikes that you just identified seems to correspond with some critical time periods faced by California, its regulators, and the Legislature itself, example being in the spike that goes up four additional pages embraces the infamous December 8th, 2000 date in which our California ISO went to FERC and asked for the price caps to be eliminated here in California.

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As we go forward, you look at the other spikes, and they seem to embrace the time periods when this Legislature was voting on some critical issues relating to the electricity crisis as well.

MR. DRIVON: The price of natural gas directly affects the price of gas-generated electricity; right?

MR. CARPENTER: That's correct, and particularly in California.

MR. DRIVON: Because in California, the majority of our non-hydro, non-nuclear electricity is generated with natural gas.

MR. CARPENTER: Yes, and therefore under the old PX scheme, the bids from a natural gas-fired generator would be the bids that would be setting the market price.

MR. DRIVON: Except for oil-fired generation, which, with a market clearing price, might move the price even higher.

But to substantiate a price above a cap, where it was a soft cap, you could use the price of natural gas to do that; right?

MR. CARPENTER: That's correct.

MR. DRIVON: So, if a fellow wanted to put a squeeze on regulators or a squeeze on people who were trying to manage the market in electricity, one of the ways to do that would be to dramatically increase the price of natural gas, which then would be used to manipulate the price of electricity; right?

MR. CARPENTER: Yes. Or another way of saying

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that is, during these -- during those kinds of episodes, a gas-fired generator would be nearly and completely indifferent to the price of natural gas, and would be willing to pay nearly anything to get it, because it obviously could pass that through in the electricity price.

MR. DRIVON: And profit would be a percentage of cost, so that in effect, the higher the cost, the higher the profit, at least in a lot of cases.

MR. CARPENTER: In some cases, yes.

MR. DRIVON: And so, if you push the price of natural gas through the roof, increase the cost of producing electricity, affecting thereby the effective supply, you put an enormous amount of pressure on people to eliminate caps on the price; don't you?

MR. CARPENTER: It would have that effect, sure.

MR. DRIVON: December the 8th of 2000 would be just about at the top of that clear-past-the-ceiling point of natural gas; right?

MR. CARPENTER: That's right.

MR. DRIVON: And the 8th of December of 2000 is the day when, at 4:30 in the afternoon, all of the FERC Commissioners happened to be present on a Friday in Washington, D.C. when, without notice to anyone else, Terry Winter of the ISO went to Washington, D.C. and got those caps lifted after a series of letters from the electric generators, talking about how they were being squeezed by the price of natural gas; right?

MR. CARPENTER: Sounds right.

MR. DRIVON: Do you think that was a coincidence?

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CHAIRMAN DUNN: Is that a rhetorical question?

MR. CARPENTER: It's a rhetorical question. You know better than I.

I'm some what conscious of my time, so we'll try to speed it up a little bit.

The next thing we're going to focus on is Merchant's nomination activities during this time period. I think I mentioned that during these periods, they were not making all of their gas available.

CHAIRMAN DUNN: Paul, before you go into that, lay definition when you say "nominations." What do you mean?

MR. CARPENTER: Thanks. There's essentially three things that happen on a gas pipeline in order to get gas to flow.

First you have to nominate a supply to the pipeline. And El Paso, like most pipelines, has four cycles of nominations. They start the day before a day of gas flow, and there's two times during that day at which you can nominate. And then there are two nomination cycles on the day of gas flow.

So, you nominate. Then El Paso seeks a confirmation of that nomination, that you in fact have a buyer on the other side. When it receives that confirmation, then it schedules. And there are various complexities on El Paso as to their scheduling process, but basically you nominate. It gets confirmed. And then it's scheduled.

But you can't get any gas to flow unless you nominate. I think one of the attorneys at the trial said, you

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can't get into Harvard unless you apply; right? That's right.

So, what we're looking at here in these data are the nomination behavior of Merchant -- are they even trying to flow all of their supply -- as well as the ultimate utilization of their capacity.

So, this is an exhibit directly from the hearing. What we've done here is, we've plotted the nominations of and flows of Merchant and all the other shippers combined. So, we've separated Merchant out.

MR. O'LOUGHLIN: These are other shippers on El Paso's system to California.

CHAIRMAN DUNN: For those who can't seen the screen, the only line that's up there is the very top line, starting around 90 percent to the far left-hand column, and staying pretty much there across top of the page.

MR. CARPENTER: Yeah, and running up to 100 percent pretty much throughout this period. It starts at 90.

This blue line is the nomination behavior of all of the other shippers to California on the El Paso system.

And the time period we defined here is from the start of the El Paso Merchant contract to the end of March, 2001, which was the time period of the first FERC hearing.

Then if you look at how much of that other shipper gas flowed, that's this next red line.

CHAIRMAN DUNN: Also starting about 84, 85 percent, and then kind of up and down, but somewhere in that vicinity across the page.

MR. CARPENTER: Across the page. And this

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reflects kind of the scheduling friction and whatnot on the El Paso system. But basically, the other shippers were trying to move as much gas as they could during this entire period.

You'll note in August of 2000, there is a downwards spike. That reflects the explosion on the pipeline. So, the other shippers were continuing to nominate at, you know, 100 percent of their capacity, but in that case, they got cut because of the explosion.

Now, in black, we're going to display Merchant's nomination behavior on the pipeline.

CHAIRMAN DUNN: And this is the line that starts at about 30 percent, winds its way up about a third of the way into the page. That's the line we're talking about.

MR. CARPENTER: Yes. There was some volatility in this, but they started at about 30 percent, kept it at about a 30 percent level until about June of 2000. So, that's like taking 800-900 billion cubic feet a day off the table, off the market. That is as big as shutting down the Kern River pipeline. It's bigger than shutting down the Kern River pipeline. This is a big block of idled of capacity.

CHAIRMAN DUNN: At a critical time period.

MR. CARPENTER: At a critical time period.

Then they ramp up to an about 70 percent in July, drop down to 50 percent.

Interestingly, after the pipeline explosion, they dropped their nominations. None of the other shippers dropped their nominations, but they did. We're never quite sure why that would be the case. Why wouldn't they still try to move gas

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through?

And then the nomination behavior increased to the point where, in November, where we saw that the price effects just went crazy, they are effectively nominating 100 percent of their capacity. So, it's not like they can't do it. It's not like there's some physical reason why they can't nominate 100 percent of their capacity. If it's economic to do it, they can do it.

And you'll see that there's three periods in post November of 2000 where they dropped their nominations. The one in January, the first two weeks in January is the one I focused on earlier, where I said we think that was an attempt to prop the price up after it dropped from the astronomical levels down to merely exorbitant levels.

That's what the data show.

Then we plot the final line here, which is in yellow and a little bit hard to see. But that's the actual flows on the system of their capacity.

You can see that what they nominated in those early days through the summer of 2000 basically they could flow. There wasn't any -- any constraint there.

I'm going to --

MR. DRIVON: Let me ask you a question about that actual flow business.

I just was trying to look there, where it said about August and September of 2000, about the time that the pipeline blew up in Carlsbad, hasn't El Paso said that the reason that the pipeline blew up in Carlsbad was because they

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were pumping too much gas through, and it was running at too high a pressure? Isn't that their excuse?

MR. O'LOUGHLIN: I'd be surprised if that's the case, because --

MR. DRIVON: I know it's not the case, but I thought I had heard that as an explanation. But I guess I'm just fantasizing again.

MR. CARPENTER: Not that we're aware of. There was an investigation at the Department of Transportation, Office of Pipeline Safety. I think they're about to produce a report about that incident.

One of the preliminary results, I think, that I had seen reference to in the trade press was the notion that that portion of the pipe had not been subject to internal maintenance activities because of some configuration of the pipe. So, it hadn't been maintained.

That's about the extent of my knowledge of that.

MR. DRIVON: It's obviously not over pressure at that kind of capacity.

MR. CARPENTER: No, although you have to -- on the El Paso system, you have to look at different parts of the system to -- it's not just a straight pipe -- to get a feel for how pressure is impacting its abilities. And we'll talk about that later, when Matt talks about the pipeline's own activities.

I'm going to quickly move through the next.

I talked about that first 11 days in January of 2001. This is, again, another exhibit from the FERC hearing,

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and the last phase of the FERC hearing.

CHAIRMAN DUNN: You're up to Page, I think, 19 in the packets that everybody has. We've skipped the two before that.

MR. CARPENTER: Right.

This shows every shipper on the El Paso system to California listed on the left and their capacities on the system. And it shows their nomination behavior during these days, the last week in December and the first 11 days of January.

And you can see, where there's a dash, that means they're nominating every cubic foot of capacity that they have under contract. And you can see that it's pretty uniform, that starting in January of 2001, for 11 days, El Paso Merchant pulled 200-400, up to 600 million cubic feet a day off the market during that time period.

Now, their rational for that is, their defense on that argument is to say, well, prices were falling, or that prices had fallen so low that it was no longer economic for us to move -- for us to nominate our capacity.

What that explanation fails to do, however, is explain why you didn't see that behavior with any of the other shippers that held the capacity.

Now, they make further -- they carry the argument further with arguments about how their blocks of capacity are less, are somewhat inferior to the blocks, the capacity, that other parties hold because they don't have primary rights to the most attractive delivery points.

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But the fact is, even if you look at the most inferior paths of the El Paso contract, even those paths were in the money, meaning economic to move that during that time period. And so, in our view there is no economic answer for why it made sense to withhold this amount of capacity from the market during this time period, unless your goal was to attempt to prop the price back up.

Okay, that concludes the discussion of Merchant's behavior. We're now going to focus on the pipeline itself. I'm going to turn it over to Matt.

MR. O'LOUGHLIN: Let's go ahead and pop up the graph here on the next page.

SENATOR DUNN: Hold on, Matt, one second.

If you don't mind, we're going to take a real short break here, no more than five minutes. Give Evelyn the time to rest her fingers and change paper. So, a five-minute break. We'll be back, as I said, in five minutes.

[Thereupon a brief recess was taken.]

CHAIRMAN DUNN: Evelyn asked me to remind folks that the transcript of today's hearing, when it's transcribed, will be posted actually on Senator Morrow's website that he has, that has all of the other transcripts and other information. So it will be available there.

If you have any specific questions about it, feel free to give my office a call and ask for either Alex or Ronda. It's the two individuals that are sitting right up here. They can certainly answer any questions about the status of it, and

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how to obtain it, et cetera. We'll try to leave Evelyn alone as much as possible.

What we're going to do as far as scheduling, so that everybody is aware, Matt is going to finish the presentation from The Brattle Group. We expect it to be about 15 minutes or so.

We will then break for a short lunch. We will come back. I know the PUC representatives here -- we'll see. It depends on how long, Matt, you go. We may do the PUC right at the end of Matt's.

We'll be through by 12:30. We have to be, because I have to do something across the hall at 12:30. Then we'll be back here at 1:00 or 1:10, someplace in there, to begin the afternoon session.

So, we're almost on track, but we may have to amend it just a little bit.

Without any further ado, Matt, carry it on.

MR. O'LOUGHLIN: Paul had spoken a bit about the Merchant's behavior.

I'm going to talk a bit about El Paso Natural Gas, the pipeline. And the graph we have up here is -- we have not laid in the black line above it that shows up in your presentation, but I wanted to start here because this is the way Phase I of the FERC hearing ended up.

CHAIRMAN DUNN: Let me interrupt, just so the audience is tracking.

The graph, where is this one?

MR. O'LOUGHLIN: It's just before Page 20, what

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is numbered as Page 20.

MR. CARPENTER: In your presentation.

CHAIRMAN DUNN: We've got the transcripts. We've got the clips from the two. We've got a transcript that's Page 20.

So what you're saying is, it's before Page 20. Before 20 was the last graph that Paul just talked about.

MR. O'LOUGHLIN: This one graph that has green and blue on it.

CHAIRMAN DUNN: Let me get everybody to it.

Right after Paul finished the one, the next thing that we have on Page 20 is a partial transcript.

MR. O'LOUGHLIN: I'll come back to that in a minute.

CHAIRMAN DUNN: The next page we have is a document stamped "CONFIDENTIAL, Subject to Protective Order," that says "SCE-233" in the top right-hand corner.

MR. O'LOUGHLIN: I'll come back to that, too.

CHAIRMAN DUNN: Then it's the next page that you're talking about; right?

MR. O'LOUGHLIN: That's correct.

CHAIRMAN DUNN: Which is marked "SCE-130."

MR. O'LOUGHLIN: Yes.

CHAIRMAN DUNN: I want to make sure everybody's on board on which one we're dealing with.

MR. O'LOUGHLIN: As I said, this is -- El Paso presented this at the end of Phase I. And there was a bit of a surprise here because, as I had mentioned to you earlier, El

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Paso's position over the prior few years was that there was excess capacity on the El Paso pipeline system, and excess capacity was a problem.

What this graph was put forward to depict was that in fact they now had a capacity constraint. They had a capacity shortage problem on their pipeline, and this was the first time that we heard the argument.

And so, the blue depicts total westward flow on the pipeline to both California markets and East of California markets. And these East of California markets are the ones in Arizona, New Mexico, and Texas.

CHAIRMAN DUNN: Let me interrupt again. I'm sorry, Matt. Some do not have a color copy.

The blue is basically the bottom shaded area, the biggest shaded area on the page.

MR. O'LOUGHLIN: And you can see that increases from about 2500 MMcf/d in February through May of 2000, up to about 3500 or 4,000 MMcf/d by the winter period.

There's also a green shaded area where, on the left-hand side, it's the text,

"Mr. Somerhalder's Reported
Available Capacity to Serve
California and East of
California Flows,"

shows up. And there is a significant amount of that green available capacity in January and February of 2000, all the way through June and July of 2000, but it starts to disappear in late July, at which point, according to El Paso, there was

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really very little available capacity left on the pipeline system.

We went back and took a look at their certificated obligations. And up to that time, what El Paso had been putting forward was this notion that, gee, maybe there were constraints at the California border. Then it was, gee, due to Carlsbad and maintenance, we have these capacity problems.

So, we went back and took a look at their certificated capacity, and laid in the black line. It turns out their certificated capacity to California and to East of California markets is on the order of 4500 MMcf/d, or 4-1/2 billion cubic feet per day.

And we adjusted it for all maintenance activities that they had shown, and we also adjusted it for the Carlsbad rupture. So, you can see the big drop in the black line in August of 2000, which reflects the initial loss of capacity due to the Carlsbad rupture.

Within two or three weeks they had brought back much of their system, so that the kind of reoccurring loss due to the Carlsbad rupture, according to El Paso -- we are taking them on their word with regard to these numbers -- was about 270 MMcf per day. And that's why you see that the line remains lower from September of 2000 through, say, March of 2001 relative to where it was in the earlier months.

So, we had taken into account the Carlsbad rupture, and we took into account maintenance, and what we found was, there was still a significant amount of unexplained capacity that appeared to be unavailable on the El Paso system,

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this white area in between the line and the chart that Mr. Somerhalder had presented, was unexplained.

Now, they've put forward subsequent to that time explanations regarding shipper imbalances, and uneven hourly flows, the failure of upstream pipelines to deliver at high enough pressures, temperature issues. They've tried to address that. A lot of the Phase III portion of the case went to addressing the reasons that they put forward to explain why this capacity did not appear to be available.

Before we leave this graph, one thing I want to point out to you is, you can see how the loads, the blue, runs up, increases from, say, May of 2000 to August of 2000. And one of the arguments again that El Paso put forward was that their East of California loads suddenly increased in the summer of 2000, and that this was a big surprise to them. Unexpectedly, there was a lot more demand in Arizona and New Mexico than they had anticipated, and because of that, they just couldn't provide pipeline capacity to California to the degree that they were contractually committed. I'll address that in a minute.

Why don't we go now to these hearing transcripts.

CHAIRMAN DUNN: Now we're going back --

MR. O'LOUGHLIN: To what is now Page 20. That's titled "EPNG," the pipeline, "Knew Its System Was Tightening Before [Merchant] Acquired Its Capacity."

CHAIRMAN DUNN: Hold on one second.

Senator Johannessen.

SENATOR JOHANNESSEN: The capacity you said east of the Rockies.

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Were there in any attempts to see whether or not that was because of a contractual agreement, or because it was actual use of the gas that was flowing to the east?

MR. O'LOUGHLIN: The capacity that El Paso makes available is designed to serve these East of California markets in Arizona and New Mexico. They are -- most of the contracts there are what are called full requirements contracts. That obligates El Paso to deliver whatever gas is necessary to meet the loads in those areas.

The capacity that El Paso is obligated to deliver to California is contractually based. It's a certain contractual amount that they are obligated to provide.

Now, the flow is the loads that I showed you. That was actual gas that moved through their pipe.

But the problem we were having was that the capacity of their pipe was larger than the flows that they were moving. And we were trying to understand why they could not move more gas to California through the pipe.

They have not fully explained why they did not have the amount of capacity available that they were supposed to have available.

SENATOR JOHANNESSEN: Who are "they" that cannot explain.

MR. O'LOUGHLIN: This is El Paso Natural Gas, the pipeline.

SENATOR JOHANNESSEN: Thank you.

Mr. O'LOUGHLIN: So, on Page 20 there's two pieces of evidence that are interesting. One comes out in a

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hearing transcript on June 18th of 2001. This is right at the end of the Phase I hearings. Mr. Lipson of Edison is questioning Mr. Somerhalder of the pipeline.

And just to summarize the point here, what comes out of this cross-examination is that Mr. Somerhalder admits that El Paso would have known as early as January 3rd of 2000, and subsequently by April 27th of 2000, but certainly by January 3rd of 2000, that the loads East of California were large enough that El Paso could not meet its East of California commitments and its California commitments under the current state of its system.

So, that was a situation where, again, the pipeline knew this prior to Merchant acquiring its capacity, acquiring the 1.3 bcf per day of capacity on the pipeline.

Subsequently, Paul testified -- and the date here is incorrect. It's February 22nd of 2002. It was this year. And you can see, there's a question and answer taken out of the public portion of his testimony.

The point here is, if you look at EPNG'S 2000 Strategic Plan, which was prepared in late 1999 -- first of all, El Paso pretty closely forecasted its month-to-month loads on its system throughout 2000. It anticipated the flows it was going to experience on its pipeline throughout 2000. So, there was no sense in which the loads on its pipe in the second half of 2000 were some sort of big surprise.

The second thing that comes out the Strategic Plan is that El Paso had forecasted that starting in late 2000 and 2001, it was going to have dramatically higher loads on its

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pipeline, in part due to new power plants coming on line in Arizona and New Mexico, in part due to the Mexican markets it started to develop, and in part due to growth in California. And so, it knew that the demand was there and was growing.

So, I would point out to you -- I'll come back to this in a second -- they knew there was unmet demand showing up on their system, on El Paso's system.

If we go to the next page, Page 21, this is a document that, again, came out in Phase III of the case. It was a memo prepared by Al Clark of El Paso, and it was prepared in June of 2000. It talks about capturing these East of California independent power plant opportunities, new gas-fired power plants that were going to be in Arizona and New Mexico.

We've highlighted one box for you, and I'll read it:

> "We need to play-out the ROFR,"

Which is the Right of First Refusal,

> "held by Merchant in a manner that will be responsive to the needs of the IPP requirements and time frames. If the Block I capacity can be sold to these East of California IPP projects, and thus taken out of the California market, the value of Block II and III to California may be enhanced."

There's several points you can take away from

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this. One is that at the time, El Paso was aware that the California capacity, the Block I capacity that was going to California, could be used to serve new loads East of California.

It also makes it clear that they recognized that by taking the capacity out of California and redirecting it to East of California markets, that could serve to increase the value of other transportation. It could serve to push up basis differentials or expand the basis differentials between the producing basins and the California border.

This is one of the documents that the Chief Judge found in Phase III of the case to be evidence of intent on the part of El Paso the pipeline to exercise market power.

Before we leave this, I would just point out to you, at the bottom of the page, just above the words, "North Mainline," you'll see that it says:

"Requests for capacity on El Paso's system have been numerous. Detailed below are the requests identified by area on the system."

So, I just wanted you to see what's going to show up in just a minute here, that El Paso knew it had unmet demand on its system; it knew by the summer of 2000 that IPP developers in East of California were looking for capacity on the system.

Now what I'd like to talk to you about is how they handled what's called Line 2000, or the conversion of an oil pipeline to gas use.

On the screen now is a letter that was sent to Al Clark of El Paso from the Federal Energy Regulatory Commission

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on January 3rd of 2001. So, it's right in the middle of the winter of 2000 and 2001.

What it points out, and these areas are highlighted in yellow on the screen, first, that El Paso had filed an application on August 31st of 2000 to convert the crude oil pipeline to a natural gas pipeline, and this was known as the Line 2000 Project. This is a project where the pipeline parallels the southern line on El Paso's system.

The other key sentence is at the bottom of the second paragraph. It says,

"The application,"

this is the application filed by El Paso,

"characterizes the proposal as a loop line to replace compression and results in no increase in system capacity."

So, El Paso had not filed the application saying, gee, you know, our market's growing, we need more capacity. They had filed it saying, we're going to take compression out of our existing system and just replace it with this pipe. So, the amount of capacity we have to serve the market is not going to change. It's going to remain the same as to what it is was before.

And what FERC is saying in the subsequent paragraph as you can see here is,

"With the current difficult energy situation ... and the consequent need to examine all possible

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options ... I'd like to know whether El Paso has evaluated ... converting Line 2000 [as an] expansion, [as opposed to just] a system replacement."

Couple of weeks later, on January 15th, 2001, El Paso writes back to the FERC. Why don't we go ahead to the second page of that. And we've put in red one paragraph which we think is relevant. El Paso's response at that time is,

"El Paso is certainly interested in providing additional transportation service and will expand its system if support for an expansion project can be obtained."

And then it goes on to say,

"At such time as El Paso determines that there is unmet demand for additional capacity to serve the markets accessed by its system and that shippers are willing to enter into contracts to support that capacity, it will evaluate whether an expansion of the existing system or a modification of Line 2000 ... is appropriate."

Now, I've just gone through for you -- this was

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in January of 2001. You know, six months earlier, or seven months earlier in June of 2000, it realized there were plenty of IPP developers that wanted capacity and were willing to contract for it. Twelve months earlier, in late '99, it knew that it had unmet demand on its system.

So, there seems to be some inconsistency in the statements that El Paso's making to FERC in January of 2001 as compared to its other documents.

I'm going to jump ahead here --

MR. DRIVON: Excuse me. Let me ask you a question.

So, this is in January of 2001. And they're trying, it sounds like, to make it sound like they really don't have any ability to expand pipeline capacity into California. They're trying to avoid admitting that they do; right?

MR. O'LOUGHLIN: That's correct.

MR. DRIVON: And then, to one extent or the other, they're able to convince the FERC that that's true, and it'll just reduce gas pressure, or cause it to run around in circles, or whatever their reason was; right?

MR. O'LOUGHLIN: Yes.

MR. DRIVON: And then, in addition to that, within three or four months, they enter into this sweetheart capacity deal with their subsidiary Merchant who, as we will find out later, turns around and lays off a bunch of that through a partial release contract with Enron; correct?

MR. O'LOUGHLIN: At that point, they're -- they have this contract with Merchant. Their affiliate is making a

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lot of money over the tight supply demand situation on their pipe system.

MR. DRIVON: So now you've got a double squeeze. You've got a failure to increase capacity that they have the ability to do in a relatively short period of time through a pipe that already exists, but they claim is just going to run around in a circle.

And the second part of the squeeze is, they're working out a deal with a subsidiary of theirs that they're not supposed to have deals with because one's regulated and the other's unregulated. And then they're getting Enron involved in this process that's running Enron On Line that's reporting pricing to the industry publications that's going to help set regulated prices. And all of this is happening within about a four or five month period of time.

MR. O'LOUGHLIN: We're seeing throughout 2000 and 2001, yes, this notion that the pipeline has a strong incentive to tighten the supply-demand balance on its system; basically tighten up its system. And it not only benefits the pipeline, but it benefits its affiliate that is now holding the vast majority -- well, a large chunk of the capacity on the pipe.

MR. DRIVON: So, the benefit is going to the pipeline and to Merchant, and to their counterparties with respect to some of these, most notably which might be Enron, and the benefit's going that way.

But the detriment is done to the pocketbook of the California consumers who have paid through the nose for both gas and electricity as a result of all this; right?

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MR. O'LOUGHLIN: That's right.

Let me go to Exhibit SCE-253, jump a couple ahead.

This is one of the summary slides from Phase III of the case. And Phase III of the FERC case was designed to be a limited hearing that was really focusing on El Paso the pipeline had capacity that it did not make available, and also whether there was actually demand for that capacity, whether there was valid, firm, and interruptable nominations that went unserved.

I know this graph is a bit busy, but if you first concentrate on the black line, what the black line is meant to show is the evidence that was put forward by two Southern California Edison witnesses, Rick Santerre and Mendel Yoho, one of which is a pipeline scheduling expert, and the second of which is a pipeline engineering expert.

CHAIRMAN DUNN: This is the one that you've labeled "Additional Available Mainline Capacity?"

MR. O'LOUGHLIN: Yes, that's true.

CHAIRMAN DUNN: All right. I just want to make sure everybody is on the right line.

MR. O'LOUGHLIN: That's a good point. It's the thick, bold, black line.

And what this measures is the amount of additional capacity that Mr. Santerre and Mr. Yoho found should have been available on El Paso pipeline but was not made available during the November through March time period.

And so on the left-hand side, you can see the

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number gets up as high as 500,000 -- or 500 MMcf per day, or 500,000 Mcf per day. Throughout most of December, January, and February, the numbers were a little over 200,000 Mcf per day. So, it's a fairly significant amount of capacity that El Paso did not make available during the winter time period. That was responding to one FERC question.

The graphs, the sort of black and gray areas, shaded areas, represent nominations by shippers in California, people that had nominated capacity, both firm capacity and what's called interruptable capacity, trying to use that capacity or move gas to California but were unable to move gas and had their nominations what's called cut or reduced due to the lack of capacity on El Paso. So, it's essentially showing the commission had El Paso made the capacity available, there was plenty of demand to flow gas on that capacity. That was the -- what the evidence showed, looking at El Paso's own records.

And that was really the focus of Edison and the CPUC's case during this phase of the proceeding.

MR. CARPENTER: If I could just add one comment.

It's pretty much agreed by the economists that testified on both sides that really all that you needed was an additional 50 to 100 million a day to bring prices back down to competitive levels. Demand was so inelastic that all you needed a relatively small additional amount of supply. So, this 200-250 million a day that's not being made available operationally by the pipeline is significant enough, in and of itself, to have produced the problem.

MR. O'LOUGHLIN: Let's go to Page 30 here. On

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Page 30, we've taken a few quotes out of the Chief Judge's recent initial decision regarding the pipeline. And based on the evidence I just reviewed with you, what the Chief Judge found was that El Paso the pipeline had withheld large amounts of capacity that could have flowed to California; that this substantially tightened the supply of natural gas to California.

In the second paragraph that we have here what it points out is that the actions or the means by which El Paso pipeline did this was things along the lines of not operating at or near MAOP, or Maximum Allowable Operating Pressure; with untimely, nonessential maintenance; by looking to expand into the East of California markets and the Mexican markets without having sufficient capacity to do that, as well as meeting its certificated obligation to California.

Then if we go again to the next page, again, I'm just reviewing quickly some of the highlights of the decision. The Chief Judge in the first paragraph reaffirms his finding from a prior initial decision that was issued in late 2001, that El Paso the pipeline and Merchant Energy were guilty of affiliate abuse and violations of affiliate conduct.

In the second paragraph, we point out that the Judge found that Merchant had the ability to exercise market power. But the Judge was unable to find it could, that El Paso Merchant, the unregulated affiliate, did in fact exercise market power. He was still unable to find or convince himself that the evidence showed clearly that Merchant had exercised it; although he recognized that they did have the ability to

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exercise it.

And then finally the Judge recommended that FERC go forward with penalty procedures in the case.

So, given all this, what has -- what has been the harm to California? On Page 32, we put forward some of the estimates we've had in the FERC case with regard to some of the harm. On the top half of the page, we show the effect on gas customers of the overcharges that resulted from paying prices at the California border that were far in excess of what one would have expected had you been able to buy gas in the Basin and transport it to California under competitive prices.

The number that's been put forward in the FERC proceeding is $3.7 billion, and you'll see that in the first column under "Gas." And that represented the period March 2000 through March 2001 for both gas that flowed to Southern California and to Northern California.

This really covers just gas that's not being bought by local distribution companies, or customers that are buying the gas back in the Basin, but only those parties that are buying gas at the border and having to pay the prices at the border.

We updated this to include April and May of 2001. There's a typo there. It should say 2001. During those two months, it was an additional $1.3 billion. So that over the entire EPME, or Merchant contract period, the 15 months, you're talking about $5 billion in overcharges in gas.

And as we have discussed earlier today, that gas was purchased by electric generators, and it results in higher

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electric prices. And so, we've estimated for Southern California Edison the sort of harm or the damage to the electricity market due to excessive gas prices. And a conservative estimate of that would be a billion dollars for March of 2000 through March of 2001 for Edison alone.

This includes both the fact that they had to pay more for PX electricity because the generators that were selling into the PX were paying higher prices for gas, and it also reflects that with regard to qualifying facilities, or QFs, those costs were higher because the qualifying facilities based their costs on the California border price for natural gas.

Then, just to wrap up here on Page 33, one of the things we looked at is El Paso Merchant Energy's profits. In the first three rows, we report information that was provided by Merchant itself during the FERC hearing. I would suggest you concentrate on the row labeled "Profits (Before Taxes)," which is in bold. You can see for the period March through December of 2000, those profits were 105 million.

Then the next column says first quarter of 2001, there were additional profits of 79 million.

And then for March 2000 through March 2001, Merchant said it made profits before taxes of 184 million.

Now, I would point out that Merchant said that it hedged much of its capacity, as we talked about earlier. So, those are actually shown in the row directly above it.

What it really says is that if we just stay on the far, right-most column, the March 2000-2001, Merchant really made $875 million from its physical sales of gas through its capacity. In essence, removing gas from the Basin to the California border, it made $875 million. It did a lot of hedging, and with those financial hedges, it says that it lost $691 million, which is shown in the second row. So, after you take account of that, the hedging losses, you ended up with profits of $184 million.

Now, I would point out that if Merchant engaged in financial transactions or hedges where they lost $691 million, that means other parties out there were the counterparties of those transactions and had made $691 million relative to Merchant's hedges.

So, we can speculate about who those parties are. There's a number of different players that are in that market.

Lastly, there are two other places where Merchant would have made money. One is in increasing its QF profits. It owns QFs in California. We estimated that it made $86 million in profits -- or an increase in QF profits of $86 million during that timeframe.

We were unable to estimate the increase in their electricity trading profits because the information was not disclosed. We were not able to sort of adequately estimate that figure.

MR. DRIVON: So, you've got, it looks like, around $270 million worth of profit, much of which was gained through a sale of pipeline capacity that cost them 38 million?

MR. O'LOUGHLIN: That's about right, yes.

MR. CARPENTER: Yes.

MR. DRIVON: Not bad.

MR. O'LOUGHLIN: Very lucrative.

MR. DRIVON: Just trying to get down to the bottom of this, El Paso is a regulated entity, the pipeline?

MR. O'LOUGHLIN: The pipeline is, yes.

MR. DRIVON: They've got this subsidiary corporation that they own called Merchant, but nobody regulates them; right?

MR. CARPENTER: Yes, although they operate under affiliate rules that they -- codes of conduct that they are --

MR. DRIVON: Which means that they're not supposed to talk to each other for the purpose of making a profit.

MR. CARPENTER: Yes.

MR. DRIVON: That's a simple way of putting it.

But we've all ready figured out from looking at these documents here that these affiliate rules were not exactly chiseled in stone between El Paso and Merchant, since El Paso's talking about how they can use Merchant for the purpose of pushing up the price at the California border.

MR. CARPENTER: Correct.

MR. DRIVON: You have documents on that; right? I mean, this is not somebody's imagination.

So, to one extent or another, they're ignoring their affiliate rules. And when they can't make their deal for this pipeline capacity, which they first aggregated the pipeline capacity by getting releases back from people like PG&E, who thought they were holding excess capacity.

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And then, they tried to make a deal with Enron for that pipeline capacity. Everything was fine until even the FERC couldn't stand it and said, you've got preferential delivery rights here, and we're not going to let those stand, at which point Enron says, we're out of here on that contract; right?

MR. CARPENTER: Correct.

MR. DRIVON: And then, Enron and El Paso have a problem because Enron isn't in on the deal, and El Paso's still got this pipeline capacity that they need to do something with for a profit. So all of a sudden, by total chance and coincidence, Merchant, who is doing the bidding of El Paso, at least according to these memoranda that you showed on the screen, becomes an intermediary party between El Paso pipeline and their former partner Enron. And they put the deal together through the back door; right?

MR. CARPENTER: Possibly. I mean, we don't know for sure until we see those documents.

MR. DRIVON: Well, I know you're a scientist. I mean, you've got a Ph.D. in economics.

But Merchant Energy here is kind of like that proverbial "put on a fence post," pretty hard to figure out they got there by themselves; isn't it?

MR. CARPENTER: I think there are a lot of red flags --

MR. DRIVON: Is that the Ph.D. way of agreeing with me?

MR. CARPENTER: -- and I think in this particular

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time period, I think some very useful discovery could be done to determine exactly what the relationship between the parties were.

MR. DRIVON: In other words, we can see pretty clearly what most probably happened here, but we'd really like to see some more specific documents, like some of the other 177 documents that preceded the one that we saw, which was only a partial document because the rest of it's kept secret by the parties, including FERC. And if we could just see the rest of those secret documents, we would able to confirm and nail down what we all can see here happened; right?

MR. CARPENTER: If they confirmed it, yes.

MR. DRIVON: Of course, it might just be a coincidence.

CHAIRMAN DUNN: A couple follow up questions, Matt, probably to you, but welcome Paul's input as well.

The 691 that's just to the right up there, the figure on the hedging losses, of the 691, do you know since they lost it, who gained it?

MR. O'LOUGHLIN: Under confidentiality agreement, I do.

CHAIRMAN DUNN: Anything that you can share with us?

MR. O'LOUGHLIN: There's a logical set of the parties. The large players in the market would be the ones the most likely to hedge. That's your Enrons of the world, some of the generators, parties of that sort.

CHAIRMAN DUNN: Am I incorrect to assume that the

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most logical largest party is probably Enron? Would I be incorrect to make that assumption?

MR. O'LOUGHLIN: I can see where that would be a reasonable assumption to make.

CHAIRMAN DUNN: I think, Paul, that you have seen a document that we uncovered in production of documents from Enron, specifically e-mail involving one of the in-house counsel to Enron. It's entitled, "The Western Region Counterparty Exposure Physical MTM."

It lists on there the largest counterparty as El Paso Merchant Energy at almost 184 million.

Can you share if you have any thoughts on what that may mean?

MR. O'LOUGHLIN: Sure. We've seen the document. There's a lot of it that's not clear. You know, there's clearly not a lot of information on it.

The notion of physical mark-to-market, would at least one thing indicate that we're talking about dollars here. We're talking about $183 million, which is a significant amount of money.

We are not aware of Merchant taking any kind of physical positions. So, it makes you wonder whether this physical is some sort of reference to some type of either financial transactions, or some type of arrangement between Enron and Merchant. And at that point, you'd be wondering if it had something to do with the financial transactions or the physical activity related to that around the California border. And some of these hedging figures that we've talked about, the

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691 million, whether it bears some relationship to that.

CHAIRMAN DUNN: Put in lay terms, it could mean -- I know you're not saying exactly what it means because there's still more information that would have to be uncovered, from your perspective -- but it could mean that with the capacity issues we've discussed already here this morning, that Enron had a significant relationship with Merchant, in fact, more significant than any other counterparty.

MR. O'LOUGHLIN: Yes.

MR. DRIVON: Can you think of any other logical explanation for that set of facts, other than the one the Senator just laid out.

MR. O'LOUGHLIN: It's clear Enron thought the capacity was valuable, and they intended to do something with it. So, I mean, given that information, and given that El Paso also thought the capacity was valuable, and Merchant intended to do something with it, it seems to be obvious that both parties would benefit from that recognition.

MR. DRIVON: Does that mean you can't think of another logical explanation, other than the one that the Senator just laid out? I mean as you sit here.

MR. O'LOUGHLIN: Yes. I'm not thinking of any other.

MR. DRIVON: There's one other point that I want to make, and that's this. You talked a minute ago about a confidentiality agreement. I certainly am not critical of you for understanding your need to abide by that.

But in the last year-and-a-half that I have been

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earning my dollar-a-month salary doing this job, we keep running into the same problem.

And nobody has yet been able to tell me what public interest is being served by the imposition of secrecy agreements that keep information that's critical to people being able to understand why their wallets were raided.

I was just wondering whether or not, in your examination of this entire thing, you have been able to learn a public policy reason to support that sort of secrecy?

MR. O'LOUGHLIN: I have not.

MR. CARPENTER: If I could just comment on that.

I think you see examples of the kinds of stuff that was protected in the FERC proceeding and then was made public. That kind of material is not -- first, it's historical typically. It's not trade secret in the sense that it somehow reveals an underlying business model that nobody else has.

So, I think there's a lot of information that could be made public that is really not of a commercially sensitive nature. But it's just the way the process works.

MR. O'LOUGHLIN: I think the California parties in FERC case have made a lot of attempts to make -- to get that information made public. And sometimes they've been successful, many times not.

CHAIRMAN DUNN: I think you phrased it correctly. Sometimes successful, many times not, unfortunately.

Unless there's any further questions, Paul, may I thank you very, very much. I know you've come a long way.

Our hope is, I don't know what your own schedules

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are, that you can be here for at least for part of this afternoon's hearing as well because I suspect there may be follow-up questions.

Thank you to the both of you.

For scheduling purposes, everybody, here's the revised schedule. We'll recollect here at approximately 1:15 to 1:20. The PUC witnesses are going to go first. This is not my estimate now, everybody. We expect them to only be on board for about five to ten minutes, very short and direct testimony. So, we expect then to get to our third panel at about 1:30.

That's our schedule, and we're on recess. We'll see everybody here about 1:15.

[Thereupon the luncheon recess was taken.]

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AFTERNOON PROCEEDINGS

--ooOoo--

CHAIRMAN DUNN: Why don't we get going.

Just as reminder to everybody, we have been constituted officially as a subcommittee of three to act in full accordance with our powers, being constituted as a formal subcommittee. Those three consist of Senator Maurice Johannessen, who is here; Senator Wes Chesbro who will be here in a few moments; and myself. With two of us here, we have a quorum established, so let's move forward.

We're now going to touch upon the presentations from the PUC representatives. This is the one that I had indicated earlier will be relatively short, and then we'll get right to our third and final panel.

Why don't we proceed forward with the introduction of the two of you, then we'll have Mr. Pratt, from Leg. Counsel's Office. Actually, why don't we do that first, Bob. Why don't we take care of swearing in the witnesses.

[Thereupon the witnesses, BILL JULIAN and TRINA HORNER, swore to tell the truth, the whole truth, and nothing but the truth.]

CHAIRMAN DUNN: It's my understanding you actually have a formal presentation for us as well to walk through. I don't know, Trina or Bill, which one I should go to first.

MS. HORNER: I'm happy to start.

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CHAIRMAN DUNN: Then why don't we start with the introduction of both of you. We know who the two of your are, but just so the audience listening in knows who the two of you are.

MS. HORNER: Sure.

I'm Trina Horner, and I'm the Chief of Staff to President Loretta Lynch at the California Public Utilities Commission. I've had that role for about two-and-a-half years.

I have extensive background on working on natural gas issues at the CPUC for about the last ten years.

MR. JULIAN: I'm Bill Julian. I'm an advisor to Commissioner Carl Wood.

I recently spent a number of months as the Legislative Director for the Commission.

CHAIRMAN DUNN: As both of you already know, because I know you've been here many time before, bring those mikes right up close to you so that we can make sure that everybody in the room can hear.

MR. JULIAN: I'd just like to add that President Lynch extends her apologies for not being able to be here in person. She's in Washington, attending to telecommunications responsibilities that she has on a national panel. She would be here if she were in the state.

CHAIRMAN DUNN: Thank you very much, Bill. She did express that to us personally as well, too. We greatly appreciate her at least desire to be here, but understanding her responsibilities in Washington, D.C. as well. Certainly, we've got well qualified replacements for her as well, too.

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Why don't we turn it over. Trina, I think you're going to start out.

MS. HORNER: Sure.

I have presented to the Committee, there's a two-page handout that I'm not going to repeat verbatim. And in the interest of time, I think what I'd like to do is just walk you through it, and just highlight it very quickly for you this morning.

CHAIRMAN DUNN: Trina, before you go on, I want to make sure our audience is up to speed with us here.

This is a document that I believe has already been handed out. It's outside. It's entitled, "Published Natural Gas Indexes are an Important Component of Retail Gas and Electricity Rates in California." That's the paper we're talking about that Trina's about to touch upon. If you don't have it, it's right outside.

My apologies to you. Go ahead.

MS. HORNER: This morning, you talked a bit about the relationship and some of the odd timing between the pricing phenomenons that we witnessed as a result of the natural gas contract between El Paso, the pipeline, and its affiliate.

There are a number of ways that natural gas prices comprise an essential building block of how the CPUC sets both natural gas and electricity rates for end use customers in California. So, what I want to do very quickly this afternoon is provide some context, a little bit of additional context for what you heard from Paul and Matt this morning.

The retail gas and electric rates are often set

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using mathematical formulas that, at their base, are founded on the published natural gas prices that are reported in various trade publications. Inside FERC is one, Natural Gas Intelligence, Natural Gas Daily, Natural Gas Week are some of the ones that we refer to, at least within the PUC, to get a benchmark of what's going on in the industry. And those prices that are reported are officially set and relied upon by the CPUC in setting a number of natural gas and electricity rates. And I wanted to cite some of the key examples for you.

The first way is through just setting natural gas rates, the rates that you and I, as end use residential customers, pay every month. Because when the utilities sign contracts with suppliers, often times -- not always but oftentimes -- the rates that they pay for natural gas are a combination of both fixed price and index, and are tied the some of the index prices that are reported in some of the publications I mentioned earlier. So, the difference in the natural gas indices, and any change in those indices, is directly passed on through your gas rates to you.

Now, that's true both for residential and small commercial customers that the PUC refers to as core customers, as well as for some of the larger end use customers, the industrial, electric generation, and larger commercial customers. Even though the utilities might not buy gas for them, oftentimes the way that those larger end use customers buy gas is from marketers under terms that are tied to the indexes that are publicly reported.

Now, so, when we saw during the winter of 2000

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and 2001 these enormous price spikes, the utility customers were actually somewhat better off than some of the larger end use customers, because the utilities have a little bit better of a balanced portfolio. But for end use customers who are buying gas through marketers at prices that were directly tied to those border price indexes, those were really the consumers who got hurt.

The second way is through the mechanism and the formula through which the PUC determines how reasonable the utilities' gas purchases were. And the way that the PUC gauges that reasonableness is to, through a formula, set a benchmark price that the utilities strive to beat. And if they are able to beat that price, then they're able to earn rewards from the ratepayers for having done better than the marketplace.

Now, the important point here is that the marketplace, the proxy for the marketplace, once again, is a bundle or weighted average of a number of the publicly reported index prices, some at the border, some in the basin, but the standard through which the utilities' gas buying efforts is judged really relies on a robust reporting, and clear reporting, of the border prices that are reported in the indexes.

The third way in which the state relies very heavily, and consumers rely very heavily on the indexes to be robust is for the setting of the price of the actual natural gas capacity. And you heard this morning from Paul and Matt about how -- about the basin price differential. And if the -- as we saw with the El Paso case, when the price that was reported at the California border, you know, went up through the roof, that

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just caused the differential to go up commensurately. And so, for both interstate as well as the intrastate pipeline capacity, both -- both of those segments of pipeline essentially are -- the value of those segments of capacity are driven by the differences at different receipt and delivery points as reported in the published gas indices.

So, strictly on the natural gas side, the prices that are published in these indices really affect not just the price of the commodity, but also whether or not the utilities' procurement of that commodity was reasonable, as well as the price of the capacity. So, it affects, you know, all segments along the value chain of the delivered end use commodity.

To move on to the next page, the indices are also an incredibly critical component and building block of how the state sets rates for electricity. And one of the key points here is that in the area of qualifying facilities, because utilities' payments to qualifying facilities, back in 1996, were established by the PUC and tied to the natural gas prices as reported at both Topock in Southern California for the Southern California utilities and at Malin along the California-Oregon border for PG&E.

And essentially, the prices to QFs have been determined by taking a weighted average, again, of those indices, and then multiplying them through a formula to account for the heat rate of their different generating facilities, and to ultimately arrive at the amount to be paid to qualifying facilities.

So in March of 2001, immediately after the

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highest part of the price run ups as a result of the El Paso contract, the PUC had to step in and change the indices used to calculate payments to QFs, and switch all of the formulas that previously had been calculated at Southern California border prices, up to using the Malin Northern California border price index because those indices were no longer reliable. And so, I think that's probably one of the most stark examples of how we've had to change our formula.

CHAIRMAN DUNN: Let me interrupt.

Senator Johannessen.

SENATOR JOHANNESSEN: Thank you, Mr. Chairman.

It didn't appear at the time the enormous difference between PG&E and Southern California in the charges to the customers.

Does this make sense based on indices which you're talking about coming through for El Paso, versus coming from the north down through PG&E territory? PG&E basically duplicated what was down south, so what real difference did it make by using to two indices? Indexes. What difference did you find?

MR. JULIAN: Bill Julian.

In 1996, what the Commission did in attempting to set the energy prices for payments to these qualifying facilities was to establish the avoided cost of Southern California Edison and PG&E respectively.

For Southern California Edison, the avoided cost was based on indexes of gas received in Southern California at Topock, and they actually identified three specific publications

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whose indexes would be used to calculate that gas cost.

For PG&E, since PG&E gets its gas from both the north from Malin, and from the south from Topock, and so they used a 50-50 average of the Southern California prices and the Northern California prices.

The extreme price fluctuations in the summer and fall of 2000 and then the winter and first quarter of 2001 were in Southern California on the Topock index, or at the Topock delivery point.

What the PUC did in March 2001 was to say, our experience -- what we suspect to be the exercise of market power by El Paso, and our experience with transactions at Topock, lead us to conclude that the Topock index is unreliable. And they said, we will not calculate the avoided gas cost for either utility using Topock.

SENATOR JOHANNESSEN: It still reflected 50 percent, or whatever?

MR. JULIAN: No. The Commission suspended the use of that Southern California Topock index for all purposes for calculating the electricity price because of the extreme fluctuations in price, or the extreme run up in price, at Southern California.

There was some run up in price at Malin for the gas coming out of Canada, but nothing like that extreme spike.

The problem that the Commission faced is that there's a statute specifically mandates the use of indexes to calculate the gas price. So, the Commission was not free, or did not consider itself to be free at that time to completely

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ignore an index.

But it used the index that it thought was the most reliable so it could comply with the statute and avoid the extreme effect that the use of the Topock index would cause for these electricity prices. That was one area where the Commission did have some ability to respond to this behavior.

SENATOR JOHANNESSEN: But PG&E claimed that the cost of gas coming from the north had so escalated that they were unable to pay for it.

Therefore, what I am asking is, what drove the price of the gas from the north, that is different than the gas that comes from the south? Or was there some correlation between the north and the south in order to achieve that particular point?

In other words, apparently there was plenty of gas coming from the north, but they just couldn't pay for it. Therefore, there has to be some correlation between El Paso gas whoever delivers gas from the north. What was it?

MS. HORNER: Historically the two price points for gas coming into California, or at the Malin California-Oregon border, the Malin point in the north, and Topock in the south, and historically those two hubs or delivery point compete against each other. And if I were to generalize, oftentimes, more often than not, the Malin price is priced just below the price of gas at Southern California. That's because -- because of the ability of California to take natural gas from various supply basins and play the price of that gas off against one another.

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SENATOR JOHANNESSEN: I understand. I've been in business a long time, so I understand what they're doing in a competitive market. They saying, hey, they can charge ten bucks down there, why should we charge five here.

MS. HORNER: Pretty much.

SENATOR JOHANNESSEN: Let's raise it.

MS. HORNER: That's right.

MR. JULIAN: But also, in the spring of 2001, there was a problem that PG&E had that was not related to price. PG&E could continue to purchase gas. There was a problem with credit, however. Sellers, particularly out of Canada, were demanding -- were indicating unwillingness to sell to PG&E because of PG&E's increasingly shaky financial condition.

In that instance, the PUC, some suppliers, and PG&E entered into an agreement that was contained, again, in an order of March 2001, providing special security for gas purchases. They essentially gave a security interest in gas and storage and flowing gas, and in accounts receivable, which satisfied the suppliers and permitted the gas to continue to flow. It was a credit -- it was a credit and liquidity issue. It was not really a price issue so much.

SENATOR JOHANNESSEN: Yes, I understand.

MS. HORNER: So, the qualifying facilities is a very good example of formula rate-making that relies very heavily on the published indices for natural gas. But it's not just at the CPUC where this type of formula rate-making that relies on natural gas indices occurs. It happens at our sister agencies across the country as well as at the FERC.

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And as a couple of examples of how the FERC relies on natural gas indices, when the FERC initially tried to remedy California's sky-rocketing electricity prices in December of 2000, the soft cap that they imposed was determined again by multiplying the heat rate of the least efficient plant by a bundle of natural gas reported indices.

On another front, the FERC has -- in August of this year, the FERC's trial staff has recommended that because the natural gas indices were likely subject to manipulation, that they recommended that the FERC not calculate any of California's requested refunds based on the actual indices, but based upon what was reported in the basin plus transportation, as opposed to anything that -- any prices that were reported at the border.

So, again it's another example of how these indices at the California border reverberate through the entire energy rate-making formulas.

We'd be happy to answer any questions if you have any.

CHAIRMAN DUNN: Thank you.

Bill, are you here just for questions as well?

MR. JULIAN: Yes.

CHAIRMAN DUNN: I think, Mr. Drivon, you had a couple questions, and then we'll get on to our next witness.

MR. DRIVON: I'll make it real short.

So these published price indexes, including Gas Daily, are used in various ways, the bottom line of which is, if

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the index goes up, consumers in California pay more; right?

MS. HORNER: That's correct.

MR. DRIVON: And what is the QF?

MS. HORNER: Qualifying facility.

MR. DRIVON: Which means what?

MR. JULIAN: It's a non-utility generator. It has a special status as allowed by FERC.

MR. DRIVON: All right. So, these indexes not only mean if they go up, it costs consumers more for gas, it also is going to cost them more for electricity?

MR. JULIAN: Yes.

MR. DRIVON: That's if the index goes up, as opposed to the actual price of the commodity.

MR. JULIAN: That's correct.

MS. HORNER: Right.

MR. DRIVON: You said that these indexes were no longer reliable, and you were just at that point looking at the numbers that were being reported and saying, this doesn't make any sense; right?

MS. HORNER: That's right.

MR. JULIAN: Yes.

MR. DRIVON: One further question. We understand that many producers and traders of gas are now simply not reporting their transactions to the index reporting groups.

And my question is whether or not the PUC has considered asking the Legislature for some help, or doing it themselves if they can, to make reporting of sales transactions for gas that is coming into or out of California mandatory, and

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connecting false reporting to the California Penal Code in some way?

MR. JULIAN: To my knowledge, the Commission has not initiated any process that would result -- that would have that result.

MR. DRIVON: Have I taken leave of my senses, or would that be something that we might consider doing?

CHAIRMAN DUNN: If I may request as the presiding to officer of the Committee to Mr. Julian, remove your official hat, and on a public interest side, should we do that?

MR. JULIAN: Speaking personally, that's certainly something which is worth exploring. Solid information that has integrity, that has robustness, is essential to the regulatory process.

CHAIRMAN DUNN: What a radical thought.

MR. DRIVON: It is currently totally lacking, and has been for some period of time; correct?

MR. JULIAN: Again, speaking personally, I think that's clearly been a serious problem in California for the last several years.

CHAIRMAN DUNN: Seeing no further questions, Ms. Horner, Mr. Julian, thank you very, very much for your testimony.

While they're excusing themselves, the Committee now calls Ms. Michele Markey to the witness table.

We'll take 30 seconds here while folks get settled in.

CHAIRMAN DUNN: Michele, do you need a minute to

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plug in there?

MS. MARKEY: If I could, please.

CHAIRMAN DUNN: While we're waiting for them to hook up, the Committee would like to welcome its member, Senator Wes Chesbro. Welcome, Senator.

Let's begin with our final witness of the day. As a properly constituted subcommittee with all of its powers, a committee of three as constituted, we have all three members, that are present, so thus a quorum is established.

With that established, if I can ask Mr. Pratt to swear in our next witness. Ms. Markey, you'll have to stand for this as well.

[Thereupon the witness, MICHELE MARKEY, swore to tell the truth, the whole truth, and nothing but the truth.]

CHAIRMAN DUNN: Counsel, for the record can you identify yourself as well.

MR. KIRTLAND: Yes, Matthew Kirtland from Fullbright and Jaworski.

CHAIRMAN DUNN: And, Mr. Kirtland, you're here representing Ms. Markey, I understand?

MR. KIRTLAND: That's right.

CHAIRMAN DUNN: If you would, Ms. Markey, can you please state and spell your name, and give us your business address.

MS. MARKEY: Michele, M-i-c-h-e-l-e, Markey,

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M-a-r-k-e-y. My business address is 2000 South Post Oak Boulevard, Suite 100, Houston, Texas, 77056.

CHAIRMAN DUNN: Ms. Markey, what I'd like to do, we want to cover some of the background, employment history, and other material. So, why don't I pose as a first question, if you could give us some of the history, educational and professional history, if you will, please.

MR. KIRTLAND: At this time, Senator, as Ms. Markey's attorney, I'm going to instruct her to refuse to provide any testimony or further information to the Committee on the basis of her privilege against self-incrimination. That would include answering any further questions, or providing any documents to the Committee.

CHAIRMAN DUNN: Counsel, just for clarification so we understand, your instruction to her, therefore, will apply to any further questions to her by this Committee?

MR. KIRTLAND: Yes, or production of documents.

CHAIRMAN DUNN: Ms. Markey, is it fair to assume that you intend to follow the instructions of your counsel?

MS. MARKEY: Yes, I do.

CHAIRMAN DUNN: As you're probably aware, we've had discussions with your counsel regarding this possibility, Ms. Markey.

Under Government Code Section 9410, when a witness appears before a committee or a sub committee of this type that has a quorum present, I as the presiding officer, have the ability to compel that testimony, despite your claim of self-incrimination.

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But under that same Government Section, Code Section 9410, you are conferred as a result of my requiring you to testify certain immunities which your counsel is familiar with.

So, with a quorum present here in our subcommittee, and with no objection from the Committee members, as presiding officer I hereby instruct you to answer those questions, and of course, confer upon you all of the rights identified in Section 9410.

MS. MARKEY: Yes, sir.

CHAIRMAN DUNN: It's my understanding, correct me if I'm wrong, you are here today as a result of a subpoena served upon you here in the State of California. Is that correct?

MS. MARKEY: That is correct.

CHAIRMAN DUNN: And as a result of that subpoena, which not only asks for your personal presence, but also for documents, do you have documents that you have brought with you today?

MS. MARKEY: Yes, we do.

CHAIRMAN DUNN: If I may, Sergeant, if you'd give a copy of those to the Sergeant.

Counsel, just so our record is clear, obviously, your instructions apply to every future question, and the same rights and responsibilities under Section 9410 apply to Ms. Markey as well for every future question here as we proceed forward.

MR. KIRTLAND: Correct. The questions,

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testimony, documents, the presentation of the Power Point slides; correct.

CHAIRMAN DUNN: Agreed counsel.

MR. KIRTLAND: Just so you're clear as to what we've given you as documents responsive to the subpoena. There's a brief index on top of the documents, as well as copies of additional materials that will be part of the Power Point presentation.

CHAIRMAN DUNN: All right.

Why don't we begin, then, Ms. Markey, if I can, and return to the original question I asked before we started down this route.

Can you give is a little bit of your background, education, and professional, starting with 1994?

MS. MARKEY: In 1994, I was working as a fuel buyer for Nevada Power. In 1996 to '97, I worked for a fuel buyer as well as transportation capacity specialist for Washington Natural Gas, which is now Puget Sound Energy.

In 1997 to 1998, I worked as a West Desk trader for Reliant Energy Services, although at the time it was known as Noram Energy Services.

CHAIRMAN DUNN: I'm sorry. It was known as --

MS. MARKEY: Noram Energy Services.

CHAIRMAN DUNN: Can you spell that for us?

MS. MARKEY: N-o-r-a-m.

And then in 1998, I went to a company by the name of Resource Data International, which was a division of the Financial Times, and was responsible for data base management

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for gas industry information.

In March of 2002, this year, I left the organization for personal reasons, and then ultimately ended up becoming a consultant for two months, working for Apache Corporation. In June of this year, I became the Director of Natural Gas for Apache Corporation.

CHAIRMAN DUNN: Ms. Markey, it's my understanding, given the comments of Counsel, that you have a prepared presentation for the Committee today; is that correct?

MS. MARKEY: Yes, I do.

CHAIRMAN DUNN: Why don't we go right into your prepared presentation.

MS. MARKEY: Happy to.

CHAIRMAN DUNN: And as you may have been sitting through some of the other witnesses, speak right into the mike, because that way everyone's going to hear you.

MS. MARKEY: I'll put it right next to my mouth.

CHAIRMAN DUNN: Perfect.

MS. MARKEY: I'm going to open up actually two presentations, ones that you've given out to everyone today, in addition to some of the documents that were created from the information that you've been provided just a few minutes ago.

CHAIRMAN DUNN: Before you begin.

MR. DRIVON: Before you begin, you indicated that for a period of time you were with Resource Data International.

MS. MARKEY: Correct.

MR. DRIVON: What were your duties there?

MS. MARKEY: Originally I was hired to create a

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data base of natural gas industry information. After May of 1998, when the company acquired Pasha Publications, which included Gas Daily and Megawatt Daily, I was put in charge of the gas price and electric price teams that gathered information from the industry.

MR. DRIVON: And this information that was gathered from the industry and accumulated there, you were in charge of the groups that did that for both gas and electricity?

MS. MARKEY: That is correct.

MR. DRIVON: And these data that were gathered, as I understand it, were then accumulated, indexed and published in the publications Gas Daily and Megawatt Daily, made available to the industry and everyone else?

MS. MARKEY: Well, if you had a subscription, that's how you received it.

MR. DRIVON: Right. You could get a subscription, and then you would get these publications.

MS. MARKEY: That is correct.

MR. DRIVON: And I think I saw you here in the audience when the PUC people were testifying a few minutes ago.

MS. MARKEY: That is correct.

MR. DRIVON: And a number of references have been made to price indexes. Did you hear them talk about that?

MS. MARKEY: Yes, I did.

MR. DRIVON: And if I understand it correctly, Ms. Markey, your job was to accumulate, assimilate, catalogue and index those price data, which were then published as the

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very indexes that the PUC people were talking about; correct?

MS. MARKEY: The price reporters who reported to me acted in that function, but I managed the group.

MR. DRIVON: All right. And it was the very data that you were managing, or the group that you were managing that produced this data, that were then published, that provided the indexes that set all of these price points and various reference points that the PUC folks were talking about a minute ago; correct?

MS. MARKEY: That is correct.

MR. DRIVON: That was your job, and you were sitting right there in the middle of it?

MS. MARKEY: Yes, I was.

MR. DRIVON: Thank you.

CHAIRMAN DUNN: Please proceed, Ms. Markey.

MS. MARKEY: This is a presentation that I gave for a group by the name of TIPROA, Texas Independent Producers and Royalty Owners Association, in June of this year. And what it was -- and I'm going to switch over to a slide presentation so you can see this easier.

I actually gave the history of the price survey. I actually walked through the processes that were involved. And I thought I could just start doing that for y'all as well in the same way that I did for the TIPROA Convention.

CHAIRMAN DUNN: Please.

MS. MARKEY: We started out with the history of the price survey, and both Inside FERC -- by the way, Inside FERC is a Platts publication, and Gas Daily was acquired by

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Platts in August of 2001.

Originally, when both publications formed in 1985, they were originally only to report physical monthly firm transactions. As more trading companies came into the business, we created daily weighted averages, which ultimately became the standard method of reporting swing gas as well as establishing what the spot market value of gas should be.

From these, quite a number of financial instruments were created, such as Gas Daily versus Inside FERC basis swaps, or Gas Data Chicago versus Henry Hub basis swaps.

This map actually shows all the various different locations where you could actually price gas. At the time that this map was created back in June, there were approximately 115 Gas Daily pricing points, including four in the state of California, which would be Malin, PG&E's Citygate, PG&E large packages, and PG&E large packages [sic].

I actually went into two different breakouts about how a monthly baseload price would be established, as well as how a Gas Daily daily price would be established. The monthly average index, I think in earlier testimony I believe The Brattle Group indicated that 50 percent of baseload gas was based on indices, whereas 50 percent of gas was based on a daily spot market price.

This procedure here actually describes how the monthly baseload was created, and survey participants were roughly 50 percent marketers, 25 percent producers, and approximately 25 percent utilities and end users.

The sample size, frankly, is smaller than what --

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CHAIRMAN DUNN: If I may, Ms. Markey, and our pardons as we interrupt you along the process.

MS. MARKEY: That's quite all right.

CHAIRMAN DUNN: We're trying to gain an understanding here as well, too. I just want to make sure everybody is understanding.

You say 50 percent are marketers. Give us some representative examples of who those marketers applies to.

MS. MARKEY: Enron, Duke, Reliant, El Paso Mirant, AEP, Williams.

CHAIRMAN DUNN: And producers?

MS. MARKEY: Producers such as Conoco, Unidelco, Burlington.

CHAIRMAN DUNN: And utilities and end users, just again, representative samples?

MS. MARKEY: Again, SoCal Gas might be one, InTex in Houston, some of the other independents -- excuse me, other utilities. It just depended on who wanted to talk to us that day.

CHAIRMAN DUNN: Thank you.

MS. MARKEY: Inside FERC, as opposed to Gas Daily -- by the way, there were two monthly indexes at the time. There was a Gas Daily monthly index and an Inside FERC index.

When we were acquired by Platts, Inside FERC made a note that they did archive all their transactions from the inception of when they started collecting prices. That was not the case for Gas Daily.

0099

And all transactions are reported in aggregated volumes rather than their individual trades. And counterparties are rarely given.

MR. DRIVON: Let me nail something down.

What you're telling me is the that you have direct information that Inside FERC actually archived their information, and at least when you last knew, had that information available; correct?

MS. MARKEY: That is correct.

The daily spot market basis was a little different, in that there were many more points that were collected on a daily basis, and the volumes were substantially greater than what you normally would see in a monthly baseload.

Marketers actually played a much larger portion in reporting, anywhere from between 60 to 80 percent of all their transactions at certain locations.

One of the things about the daily transactions is that it would include both purchases and sales. There was no distinction made between one or the other, and often both were included.

Again, there were no party -- counterparties to the transactions.

Price reporters were or did have the authority to investigate and call all questionable transactions if necessary.

This next slide actually shows three different particular pricing points. I'll actually have an overlay of each specific point in California. But this actually is showing

0100

the volume growth in selected Gas Daily points for how much volume was reported to Gas Daily.

Gas Daily began collecting volumes in 1999, and as you can see by the chart, as you get into the 2000-2001 period, volumes for various different points escalated tremendously.

MR. DRIVON: I saw this graph earlier. Let's see if we can get it identified so that folks out there will know what we're talking about.

MS. MARKEY: It says "Daily Average Reported Volumes for Selected Gas Daily Points." Yes, that's the one.

MR. DRIVON: What I was wondering when I saw this chart was, over here on this side of the chart?

MS. MARKEY: Yes.

MR. DRIVON: You've got good eyes? I mean, that's a long way.

MS. MARKEY: I've got one right here in front of me.

MR. DRIVON: Up until, oh, somewhere around April or May of 2000, the reported volumes are kind of steady across here.

MS. MARKEY: That's correct.

MR. DRIVON: And this is gas that's being supplied and presumably used by somebody who's, like, heating their house, or creating electricity, or something?

MS. MARKEY: Most of the volume at the time that I was aware of was supposed to represent physical spot transactions.

0101

MR. DRIVON: Then it all goes way up.

MS. MARKEY: Correct.

MR. DRIVON: Does this mean that -- does this represent people around the country turning up their thermostat?

It looks to me like if everybody was happy when we were down here, and then it took this much volume of gas to make everybody happy, were they baking potatoes on their coffee table? Or how high did they have to have their thermostat in order to need that much electricity or gas?

MS. MARKEY: This volume was actually -- only represented the volumes that were reported to Gas Daily as volumes traded, not necessarily usage.

MR. DRIVON: So, this just represents what appears to be a very big increase in the trading of natural gas, not the actual production, supply, or usage of natural gas?

MS. MARKEY: That is correct.

MR. DRIVON: We'll leave the rest of the questions for awhile.

MS. MARKEY: The next slide, and I won't get into too much explanation. This is just kind of a representative trade floor, and how the various different groups were broken up. And at the core was your Risk Management Group, where most information flowed in and out of in order to keep track of daily trades, daily transactions, market-to-market, accounting, invoicing.

But you can see the various different types of groups that would feed information on through and past the Risk Management Groups.

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This is just a description of a typical trade day on the floor. The trading day in Houston typically starts between 6:30 and 7:30 in the morning. Traders would normally come into the office and review their Gas Daily prices, weather reports, and determine what their open positions were for any imbalance from the day before.

Approximately about towards from, what I've been told, right around 2000, quite a number of traders also would use Enron On Line as their starting point as to what the market showed for bid asked for various different points in the market.

About the time I left Reliant, instant messaging was also a form of communication as to what was going on in the market. So, people could flip information back as forth very quickly about what they heard as far as prices, or what kind of deals were transacted during that particular time of the morning.

By the -- about 8:00 o'clock, after the trade floor would have its group meeting to talk about various things in the market and what the overall company position was, you'd immediately begin trading, which would go until about 9:00 or 9:30.

Now, this was based on when I was a trader, but typically most traders were doing anywhere between 5 and 20 deals during that particular period of time, primarily either through the instant messaging, or being on the phone. If there were any particular paper trades, you would go ahead and net those out. Paper trades meaning trades that were never intended to physically flow; they were just netted financial instruments

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to either book profit or book loss.

Then any physical trades that were done that had to be scheduled were then passed on to a scheduler, who would then have to get them into the pipeline bulletin boards for them to be scheduled. I think you heard earlier The Brattle Group refer to it as making nominations.

And then any hedges that had to be done at that particular time were normally conducted by the Structures Desk or by the Risk Management Group, either by selling futures or by selling OTC financials.

This was -- I'm sorry.

CHAIRMAN DUNN: Senator Johannessen.

SENATOR JOHANNESSEN: I'm sorry to interrupt you.

So basically, all this was done as a commodity market. That's basically what this was. It was treated as a commodity market.

MS. MARKEY: Yes, sir.

SENATOR JOHANNESSEN: You were trading like it would be a commodity market.

MS. MARKEY: Yes, sir.

SENATOR JOHANNESSEN: And this is something that apparently hadn't happened before, or on a much smaller scale?

MS. MARKEY: I believe that starting in the early '90s, when the New York Mercantile Exchange created the Henry Hub NYMEX contract, that that's approximately the time you can say that the natural gas markets began to act like a commodity, and it escalated throughout the '90s into 2000.

SENATOR JOHANNESSEN: And the relationships

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between the various players in this commodity market, there was no control over who had the ability, legal ability, to inform the various partners in this consortium, if you will, in the commodity market what to do, when to do it, how to do it, and what potential benefit there would be to do it.

MS. MARKEY: I'm sorry, Senator. I don't think I understand your question. I'm sorry.

SENATOR JOHANNESSEN: I'm trying to figure out why all these spikes took place.

MS. MARKEY: Yes, sir.

SENATOR JOHANNESSEN: We have heard testimony that some of these things was information that was internal; it should not be out because of contractual agreements and so forth.

Did anyone pay attention to this kind of a thing when you made all these calls, and contacts, and market analysis, if you will, in deciding what the price should be on any given day?

MS. MARKEY: During the time I was a trader, we would certainly be on the phone with other traders and passing along market intelligence, whether it was truthful or not. We would certainly rely on each other's discussions about the market, and where we thought the market was going. And you certainly conducted all your market intelligence via the phone or instant messages if that's what you're referring to.

SENATOR JOHANNESSEN: Right. Thank you. I think I understand that one.

CHAIRMAN DUNN: Let me, if I can, interrupt, Ms.

0105

Markey, just as a follow-up to Senator Johannessen's comments.

Given what you just responded, in your opinion is it common practice for the traders to exaggerate the prices when reporting to the indices?

MS. MARKEY: It was common industry knowledge that exaggeration was an accepted practice.

CHAIRMAN DUNN: Do you have an opinion on how common it probably was?

MS. MARKEY: In all my discussions with any other traders where this topic has come up, no one acted shocked over the topic. It was discussed.

CHAIRMAN DUNN: Okay.

MS. MARKEY: This next example is just basically a very plain vanilla walk-through of how typically a company would trade with another company or companies, and then how it would end up reporting the transactions to Gas Daily. And again, we're talking about the period that would normally occur from about 7:00 or 8:00 in the morning until about 9:30 in the morning.

So, you have a trader for one company goes and buys 25,000 MMBtu from another company at $4.30 at a particular major trading hub. That company would then turn around and sell it to Company C for $4.40 and book a profit. And typically, this was what was referred to in the trade as a paper trade, because you never you never intended to schedule this.

Finally, Company A may buy back, or goes out and buys 55,000 a day at $4.35 to cover a short position. Typically the short position was created by some kind of hedge or

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financial instrument. For instance, one of the more popular types of trades that were done is to sell what's known as a GDA, or a Gas Daily Average. A lot of the utilities like to buy these types; industrials like to buy these types of trades. They also like to buy a lot on the index. I think we heard that earlier from the CPUC.

So, the trader may sell short. In other words, he may sell gas to the utility or to the industrial that he doesn't necessarily have, but he's going to buy that gas back every day at a fixed price, and it's going to be then delivered against that short-sale index sale made to either the utility or to the industrial.

MR. DRIVON: Wait a minute now.

You're talking about establishing a tradeable derivative that is the Gas Daily index. Is that what you just said? In other words, some folks would buy and sell the index?

MS. MARKEY: Yes, that's correct.

MR. DRIVON: So then, that would be one type of derivative product that might be used as a traded commodity?

MS. MARKEY: That is correct.

MR. DRIVON: And that particular commodity, the value of that particular commodity, by its definition, was defined by the same publication that reported prices where exaggeration was an accepted practice; is that right?

MS. MARKEY: The Gas Daily index was a collection from various different marketers who may have sold on a Gas Daily index value, or bought on a Gas Daily index value.

MR. DRIVON: And reported those sales or

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purchases?

MS. MARKEY: That is correct.

MR. DRIVON: At a value that may have been accurate or, as you testified a few minutes ago, was commonly inflated?

MS. MARKEY: That is correct.

MR. DRIVON: And if someone was trading that particular derivative commodity, and that same entity was involved in reporting sales and purchases, then the reported sales and purchases could easily be used to manipulate the very index that they were trading as a derivative; correct?

MS. MARKEY: That is possible, yes.

MR. DRIVON: So by trading these derivatives and reporting the prices, these folks could just sort of decide how much money they wanted to make, and then just manipulate it around so they made it. Does that follow?

MS. MARKEY: Well, I would say that if they reported prices that were extremely out of the money, meaning out of the price range, that it would be called into question by the price reporter. It was supposed to be called into question by the price reporter.

So, you didn't want to appear too far out if you reported a transaction. But it is possible for a company to have reported a volume and a price that was within a given price range for the day that could influence what the index would have been for next day when the index came -- was published.

MR. DRIVON: Because it's a weighted average.

MS. MARKEY: Yes, it is a weighted average.

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MR. DRIVON: So, two ways to manipulate that average. One would be, you just say it cost more, or you paid more than you actually did.

MS. MARKEY: You could do that.

MR. DRIVON: The other way to do it, because it's a weighted average, would be to just say you either bought or sold a whole lot more than you really bought or sold.

MS. MARKEY: That is possible.

MR. DRIVON: And not only is that possible, but I think as your testimony goes on today, you intend to illustrate and document exactly that happening. Isn't that true?

MS. MARKEY: I'll show an instance -- several instances where I think it might have happened, yes.

MR. DRIVON: Thank you.

MS. MARKEY: Continuing on with the example, this particular company would have added all the volume of the various transactions up and created a weighted average, and then reported that average to Gas Daily.

And reporting took place in several different ways, either by phone conversation, by fax, or by e-mail.

And if you looked at all the transactions reported by other companies, you can see, a third down, the -- in this particular example, the company that traded, and their volume reported, and how it would become averaged in to create the weighted average midpoint that was then published in the following day's publication for Gas Daily.

These are basically the various ways that you were just alluding to, how trades might be reported, and any

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type of differences they may report in order to change the index.

Common practice was to exaggerate your transactions to the price reporters, report more volume, report a higher price than that was actually transacted. You stretched your price in favor of what the company's position was, or don't report at all, because you would know whether or not your indices -- your volumes and price could in fact affect the index.

Finally, transactions that were originally done at hedges -- as hedges at special prices could be considered part of the normal spot market activity done that day. Typically that should not have been included, but it was possible that people could have.

CHAIRMAN DUNN: Ms. Markey, I want to interrupt with a few questions at this point. I want to zero in on that slide that we just did on "How Well Do Trades Get Reported."

MS. MARKEY: Yes.

CHAIRMAN DUNN: Again, I know you are intimately familiar with how all of this operates. Most of the rest of us are not.

MS. MARKEY: Yes.

CHAIRMAN DUNN: And so, I want to ask some questions that may seem kind of basic from your perspective, and my apologies --

MS. MARKEY: Sure.

CHAIRMAN DUNN: -- but we want to make sure we have a full understanding.

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Can you explain in as lay terms as possible how was it a trader could exaggerate transactions to manipulate the index? How could they do that?

MS. MARKEY: Well, you never knew exactly how much you were going to affect the market. Most of the time you would trade a volume. And let's say it was 100,000 MMBtus at $2. You might report double that volume, 200,000 MMBtus at $4.

You could, instead of reporting $2, you could say, well, I'm going to report -- you've heard what the price range is for the day, and you know it's between 1.95 and 2.10. And depending on what your position is, you report either the lower end or the higher end as the price that you did your transactions at rather than the actual price.

CHAIRMAN DUNN: When you say, "depending upon your position," what do you mean by that?

MS. MARKEY: Well, depending on whether you're long or short the Gas Daily average, or the Inside FERC average, because what you to do is, is you want to, the next morning, make sure that your market-to-market position based on whatever the index comes out is, is in your favor.

CHAIRMAN DUNN: So, if I'm long, what would I like to see the next morning?

MS. MARKEY: I would like to see higher prices.

CHAIRMAN DUNN: And if I'm short?

MS. MARKEY: You'd like to see lower prices.

CHAIRMAN DUNN: So, what you're saying is that a trader could exaggerate, either inflated or deflated, its reporting to the indices which could affect that average price?

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MS. MARKEY: That is correct.

CHAIRMAN DUNN: And can you give us other examples of exaggerations? I know you touched upon some, but any others that you could share with us, again, for us to come to an understanding?

MS. MARKEY: If you didn't like where the market went that day, and you know your volumes are significant, and you don't want to influence the market adversely in your favor, you just won't report.

Or, you'll look at your day's volume, and you selectively pick out trades that would be more like in your favor so that you could say that, yes, now I've reported volumes and prices that in fact I did trade at, but you didn't include all of them.

CHAIRMANN DUNN: While at Gas Daily, were you aware of any complaints regarding the accuracy of the daily index?

MS. MARKEY: Yes, I was.

CHAIRMAN DUNN: What type of entities were making these complaints?

MS. MARKEY: Actually it was various. Primarily a lot of the end users would come to us.

Primarily during the fourth quarter of 2000 and 2001, we did have a number of end users complain, but we also had a lot of marketing companies complain.

CHAIRMAN DUNN: Can you give us some examples of who you're referring to when you say end users that would have complained?

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MS. MARKEY: There were end users such as utilities, a couple of the industrials called. I don't recall specifically right off the top of my head who they were, but the utilities were primarily the ones who called fairly -- fairly regularly.

CHAIRMANN DUNN: And if I understand what you said, the last quarter 2000 and early 2001 were a time of heavy complaints; is that fair?

MS. MARKEY: That's a fair statement.

CHAIRMAN DUNN: And can you tell us, what would they be saying in their complaints?

MS. MARKEY: Well, we received a complaint from one company that, in early January, that said that your prices were outrageously high. There's no way that the market could have traded that, and we really want you guys to go back and investigate who the larger players were, and how those high prices were actually traded.

CHAIRMAN DUNN: Did Gas Daily do anything about those complaints?

MS. MARKEY: We contacted the companies in question and demanded to see their individual transactions.

CHAIRMAN DUNN: Would they produce those individual transactions to Gas Daily?

MS. MARKEY: No, they didn't.

CHAIRMAN DUNN: Was there any additional follow-up, other than a request for the individual data that was not complied with? Was there any further follow-up by Gas Daily?
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MS. MARKEY: No.
MR. DRIVON: In that regard, ma'am, as I understand it, or as I have at least heard, there was some movement toward performing an audit on that information at this point; is that correct?
MS. MARKEY: Yes.
MR. DRIVON: And this would have been an audit that would have investigated the accuracy of the very pricing information that you're talking about; correct?
MS. MARKEY: That is correct.
MR. DRIVON: And if I understand it correctly, you were a proponent of that audit; is that correct?
MS. MARKEY: Yes, I was.
MR. DRIVON: You were trying to do your best to get that issue resolved.
MS. MARKEY: Yes, I was.
MR. DRIVON: And at that time, did you understand by reason of your position and background what the impact was if those price reports and indexes were wrong?
MS. MARKEY: Yes, I did.
MR. DRIVON: And that was part of your motivation for pushing for this audit; isn't that true?
MS. MARKEY: That is correct.
MR. DRIVON: If I understand it correctly, an audit -- a profile and procedure was drawn up; correct?
MS. MARKEY: That is correct.
MR. DRIVON: And an auditor was chosen?
MS. MARKEY: Yes.
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MR. DRIVON: That auditor was Price-Waterhouse-Cooper?
MS. MARKEY: That is correct.
MR. DRIVON: And contracts, preliminary contracts, were formed and drawn to have that audit done; isn't that true?
MS. MARKEY: Yes.
MR. DRIVON: And then, before that audit could be instituted and started, there was a change in the ownership of the publication; is that correct?
MS. MARKEY: That is correct.
MR. DRIVON: And if I understand it correctly, the prior ownership, or ownership up until that change, had been supportive of your idea that an audit should be done; isn't that true?
MS. MARKEY: That is correct.
MR. DRIVON: And the change in ownership occurred when?
MS. MARKEY: August, 2001.
MR. DRIVON: August of 2001. And when that change in ownership took place, what, if anything, happened with respect to that audit?
MS. MARKEY: Nothing happened.
MR. DRIVON: Was the audit carried out?
MS. MARKEY: No, it wasn't.
MR. DRIVON: Were the contracts cancelled?
MS. MARKEY: They were never followed through on.
MR. DRIVON: They were never signed?
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MS. MARKEY: That is correct.
MR. DRIVON: So, the audit in effect, as of the

time that ownership of the publication changed, was just quashed; is that correct?

MS. MARKEY: It never went through.

MR. DRIVON: Yeah. And at that time, one of the primary suspects with respect to improper reporting was Enron, and particularly its on-line operation; isn't that true?

MS. MARKEY: Enron On Line was the party we were going to audit, yes.

MR. DRIVON: And the publication was purchased by the same group that owns Inside FERC; correct?

MS. MARKEY: That is correct.

MR. DRIVON: Thereby consolidating the reportable indexing of these prices under that single ownership; correct?

MS. MARKEY: Correct.

MR. DRIVON: And would you please tell us, please, who the number one customer for their services was at that time when you were about to investigate Enron's price reporting?

MS. MARKEY: Enron.

CHAIRMAN DUNN: Please continue.

MS. MARKEY: This is an example, again, when I gave the presentation, I didn't specify what this location was nor the date, but this happens to be a SoCal Gas large packages location, which y'all commonly refer to as Topock.

And what I did was, and I believe it was for May 5th, 2001. What this chart represents for every single

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price point, it delineates each company total transaction volumes reported for that price.

And you can see there's a fair number of volumes reported, of which there is one very large transaction of about 905,000 MMBtus at $12.30. On that particular day, the total volume reported at SoCal Gas packages at Topock was 2.66 bcf, so it's roughly a third of the volume that was reported at that particular location for that day.

The Daily Midpoint with the volume included in there was $12.385.

If you go to the next slide, and you remove that transaction, you would see that the value would have gone from $12.385 to a midpoint of $12.43. Again, this would have -- the original midpoint would have benefitted somebody who was actually short in the market.

MR. DRIVON: That would have benefitted them by what, five cents?

MS. MARKEY: By five cents.

MR. DRIVON: I mean, five cents.

MS. MARKEY: Doesn't sound like much, unless you're a trader. And if you calculate out, somebody who has a substantial position --

MR. DRIVON: Five cents over the volumes that we're talking about on a yearly basis would be what, about $28 million?

MS. MARKEY: Yes, I believe that's what we have on our next slide.

So, if you consistently reported, over or under

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reported by a nickel at one single price point, with a volume that was consistently traded at that location, the annual change in value would have been $28 million.

MR. DRIVON: But, of course, that's only one of 115 natural gas spot market price points; correct?

MS. MARKEY: That's correct.

MR. DRIVON: So, if the over and under reporting and misreporting averaged a nickel --

MS. MARKEY: Right.

MR. DRIVON: We would multiply the 28 million, and it occurred in all the price points, we made that assumption, what we would be that talking about would be somewhere around $3.46 billion a year?

MS. MARKEY: Very possible. And I've actually got several examples of other price points.

MR. DRIVON: That's $3.64 billion a year for a nickel; right?

MS. MARKEY: Yes.

MR. DRIVON: Now, if we got it up to a dime, we'd be talking about real money.

[Laughter.]

MS. MARKEY: Since you gentlemen now have the other slides, I thought I'd just show you some of the other price points, including some other examples of Southern California and PG&E's. So, if you'll flip over to the other Power Point presentation, which these gentlemen don't have.

So what this is, is just various different examples. Right off the bat, and I apologize that this is so

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difficult to see, but this is a SoCal Gas large packages volumes and prices, 1999 through 2002.

Common economy theory would say that as more volume increases or is reported as time goes on, that the price actually flattens. This particular slide actually disproves that theory, and that is, more volume was reported on SoCal Gas large packages. In fact, volumes actually caused the price, or it looks like it caused the price to spike on a regular basis.

I'm just going to run through these briefly. I have a number of examples.

MR. DRIVON: Hold on. Before you do this brief part, can we go back to the last slide?

MS. MARKEY: This one right here?

MR. DRIVON: That one.

I remember someone was saying this morning, you might have looked at this chart here. This is a chart about what was happening with price, and then there's another chart about what was happening with pipeline capacity being withheld.

Do you remember some of that testimony this morning?

MS. MARKEY: Yes, I do.

MR. DRIVON: I was just looking at this, and at the time when the highest volumes of gas trading were taking place --

MS. MARKEY: Yes.

MR. DRIVON: I mean, is it fair to say that these trading volumes that we see here are historically unique? I mean, we never saw that sort of thing before.

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MS. MARKEY: No, we didn't.

MR. DRIVON: And these prices that these fellows were talking about, were historically unique as far as we know; right?

MS. MARKEY: Yes, that's correct.

MR. DRIVON: And although they claim -- these fellows that were trading all of this gas claimed that they were trading a whole bunch of gas at exactly the same time, we're seeing historic amounts of pipeline capacity withheld and historic prices; correct?

MS. MARKEY: Correct.

MR. DRIVON: So, how come there was so much being traded and so little being delivered?

MS. MARKEY: I don't have an absolute easy answer or an answer that I know, but I could speculate that there's a lot of turning of paper going on at this time.

MR. DRIVON: People buying and selling paper and not gas, and shipping air and not gas, and collecting money for doing it.

MS. MARKEY: That's correct.

MR. DRIVON: That happened more in California than any place else in terms of how much it cost folks out of their pocket; right?

MS. MARKEY: That is correct.

MR. DRIVON: And smack in the middle of all of this were the very same folks who were not only involved with trading this paper, but were also involved with generating electricity in California.

0120

MS. MARKEY: Many of the same players were one and the same.

MR. DRIVON: Thank you.

MS. MARKEY: This is June 19th, 2001, where there's one single -- excuse me.

CHAIRMAN DUNN: Sorry to interrupt you. Chris had a quick question for you.

MS. MARKEY: Sorry, Chris.

MR. SCHREIBER: I just wanted to touch on something that you said there.

You mentioned that intuitively as volumes rose, price volatility would be dampened?

It's difficult to see on this chart, but I just want to make clear here that what you're saying is that there's a inverse relationship between price volatility and volume, so that typically, the more volume you see, the less price volatility because of the market and it is more liquid.

MS. MARKEY: Normally you would.

MR. SCHREIBER: And in this instance, as the volume peaks here like a mountain, the price actually goes with it.

MS. MARKEY: That is correct.

MR. SCHREIBER: And is there an explanation for that from your analysis?

MS. MARKEY: I think my next slides or next couple of slides would probably give you a better answer to that.

CHAIRMAN DUNN: Let's go there.

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MS. MARKEY: What you have here is, I'm going to show you not only for California, but for several other locations throughout the United States. There is different days that I picked out with various different transactions. Each one of these represents a single company's reported transaction at a single price.

In this particular example on June 19th, 2001, there was one company that represented 41 percent of the total volume that was reported. And the midpoint of that day was 8.25.

If you took that trade out, it would have changed the volume -- the midpoint price to 8.31, a difference of 6 cents.

If I continue along with these examples, on August 2nd, 2001, there is a single company that reported 20 percent of the volume, and it created an average -- and by the way, I just would want to point out one thing about this slide, as well as a couple of the others.

You'll notice that a lot of the volumes are on the very edge of one end or the other of the price range. In this particular example, there was one -- only one other very small, small volume that was done at a price that was lower than the 3.64 that was done on this particular day.

Also notice that this volume has no corresponding equivalent. In other words, if I buy at a location, I'm usually selling to someone who is also going to report. In this particular example, there is absolutely no one who traded the same kind of volume anywhere near same kind of price that this

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company claims to have reported volume and price at.

MR. DRIVON: If someone were trying to report for the purpose of manipulating the market either up or down, or the index, I guess, would be a better way to put it.

MS. MARKEY: Yes.

MR. DRIVON: That person would be best served if they pushed the envelope with respect to either the higher or lowest price; correct?

MS. MARKEY: Correct.

MR. DRIVON: What you say that you're seeing here is that the higher volumes of trading that were reported were reported at the margins of the price; correct?

MS. MARKEY: Typically.

MR. DRIVON: But if things were flowing along in a normal way, where there was just your basic average amount of exaggeration, you would expect to see a more uniform spread of transactions over the price range for that day; wouldn't you?

MS. MARKEY: Yes, I would expect that.

MR. DRIVON: So, when you, as an expert, look at this, what it says to you is, just based on this information alone, there's a red flag that these prices aren't real; right?

MS. MARKEY: Something looks very fishy.

MR. DRIVON: Right. And then, when you overlay the fact that the volumes being reported, like the last slide, are hugely disproportionate to historic levels, another red flag?

MS. MARKEY: That is correct.

MR. DRIVON: Then when you look at the

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volatility, where the swings from day-to-day or week-to-week are greater in terms of reported trading volume than the total amount traded in an ordinary market, that's another red flag.

MS. MARKEY: Correct.

MR. DRIVON: I mean, you could get -- if normally the trading level was a 3 when this was going on, you could see weekly swings to a magnitude of 5 or 6, if you follow what I mean.

I mean, we're trading down here, and you've got this much. Then, when all of this is going on, you can see daily and weekly swings that are twice as much of what the total had been.

MS. MARKEY: That's correct.

MR. DRIVON: And some of this could be explained by what we've all heard of as round-trip trading, I guess. Is that right?

MS. MARKEY: Yes. I have an example of something that might be considered to be a wash trade or round-tripping.

MR. DRIVON: Okay.

MS. MARKEY: In this particular example, SoCal actually when you took trade out, the difference was approximately three cents.

Again, I'll just flip through these. This is PG&E's Citygate. Probably maybe not quite as volatile as SoCal Gas large packages, but nevertheless, did see its own share of volatility.

And here is a trade. And this one actually -- consistently PG&E's Citygate, there was one company consistently

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reported a large volume but always managed to consistently report approximately in the middle. So, there wasn't necessarily a change in the price in this particular example. It went from $5.15 to only about $5.16, changed at less than a penny.

Same thing on the September 11th. Again, a company who reported approximately 37 percent, and again another company that reported 33 percent. I think the important part here is, there is one company though who consistently reports a very large significant volume.

This is Kern River. This actually is a price point that is a location where --

CHAIRMAN DUNN: Let me interrupt.

You've gone through several examples. Do you know who is responsible for reporting these volumes on the particular days that you've identified here?

MS. MARKEY: At the time that Gas Daily received these, we typically would take the faxes, e-mails, and phone calls, and then within two weeks, we would destroy the documents that were sent to us.

I generally have a knowledge of various different folks who traded at the locations that we're referring to, at least here in Southern California, and the types of people who would report to us. And they're your usual suspects more or less. I have a list of the top ten traders who typically would report to us that I can give you a list of.

CHAIRMAN DUNN: In other words, Gas Daily didn't archive that underlying data.

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MS. MARKEY: That is correct.

CHAIRMAN DUNN: But given your experience, you can identify at least a list of those companies that could have reported such a large volume to Gas Daily and at least been believed by the employees of Gas Daily at that time?

MS. MARKEY: In the documents that I provided to you gentlemen today, there is a list, a partial list, but a list nevertheless of companies who typically reported to both Gas Daily to Megawatt Daily.

CHAIRMAN DUNN: Can you give us a representative sampling of those who it would not be unusual for the employees of Gas Daily to see large volumes of the trades from those companies?

MS. MARKEY: That list right there, which starts out with Enron, AEP, Reliant, Mirant, Duke, Aquila, BP, Dynegy, Sempra, Coral, and El Paso.

CHAIRMAN DUNN: Okay. Given the representative samples that you have shown here, Ms. Markey, in your opinion, what's the likelihood that these volumes, given your analysis of the data, were either exaggerated or that they represent wash trades?

MS. MARKEY: I have an example that I'm showing here. On this particular day, and this is in Columbia, Appalachia, has absolutely nothing to do with California, but it's two large volumes. In fact, the two largest volumes reported that day. Both were above a bcf of gas; both were transacted at 3.145. They were reported by two separate different companies. So, they were exactly the same volume,

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and they were the exact same price.

This is a very -- and if you look at everyone else who reported at this particular location, there's no one who comes close to the volume or the size, nor the exact price value as these two particular transactions do.

MR. DRIVON: So you mean over at Columbia APP on August the 11th, 2001 somebody was buying gas, or at least said they were buying gas, at 3.145.

MS. MARKEY: That's correct.

MR. DRIVON: And in California, we're paying $16, or something like that?

MS. MARKEY: Yes.

MR. DRIVON: I mean, a multiplier of that amount.

MS. MARKEY: The main reason I used this one is because it was a very large volume of exact quantity of exact price.

MR. DRIVON: I understand that, and maybe their copy machine got stuck.

But what caught my eye was the $3.145, and then I'm thinking about the amount of money that we're paying here in California. And I know that that represents this spread that the Brattle fellows were talking about this morning.

MS. MARKEY: Yes.

MR. DRIVON: If a nickel is three-and-a-half billion, anybody got any idea what six-and-a-half dollars is?

MS. MARKEY: It's a substantial amount of money.

One of the locations where gas could flow from in production regions was Kern River Opal. This price point is

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from November 3rd, 2001.

There was one company. Again, notice how close to the end of the range that this company reported, and they represented 36 of the total volume. If you take that particular trade out, it dropped the price by almost two cents.

And again, I can continue with as many of these examples as possible. This is Carthage Hub in Texas, where there is one company who is roughly 76 percent of the total volume reported that day.

Another company off Alliance pipeline as it went into the U.S. was 79 percent. And if I took this transaction out, it would have changed the price by about three cents as well.

Nova, which is a Canadian price point which processes a lot of gas that comes down into California, this particular party -- actually, if you look at the slide, there's only four people who reported on this particular day at AECO, and one individual company represented 81.7 percent of the total volume that was reported that day.

I just picked this, again, another price point, out of the clear blue. This is actually a point that's located in Oklahoma. Even though the price spiked, and you had a small spike in volume, you didn't necessarily see the kind of volatility that you did in California. Again, they too had a price point where one single transaction towards the end of the price range represented 65 percent of total volume. And here's what it would have looked like without that trade.

Although California certainly had a very large

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volume of reported trades on a regular basis, unfortunately I can't tell you gentlemen that y'all were the largest point ever traded as far as Gas Daily was concerned. That actually is Chicago. In the case of Chicago, in this particular transaction over 4 bcf of gas was reported by one single company at this location. But it gets better.

If you go to this particular day, which is June 20th, 2001, this is the largest amount of volume ever reported to Gas Daily for any one particular price points. One company traded almost 7 bcf of gas in one particular morning.

MR. DRIVON: Seven billion cubic feet of gas --

MS. MARKEY: That's correct.

MR. DRIVON: If I remember what that fellow in the second row back there said this morning, is just about enough gas to run California for a day.

MS. MARKEY: That's correct.

MR. DRIVON: So, you've got one company who claims that they traded enough gas in one price point in the country to run California, which has got to be far and away the largest consumer in the country in terms of a state. They did it all by themselves.

MS. MARKEY: That's what this graph would indicate.

MR. DRIVON: That's what they told you; right?

MS. MARKEY: Yes, by representing 52 percent of the total volume, it would have suggested that everybody who reported volumes on this particular chart would have had to transact with this one particular company.

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MR. DRIVON: Did you ever look to see if they had their fingers crossed behind their back.

MS. MARKEY: I want to point out, too, that this particular company for this one single transaction -- for the transactions done on this one single day, I should say, would have had to cough up $27 million just for one day's transactions.

At this time, those were just the various different examples. Again, this is the ranking of the top ten companies who would represent companies who would report to Gas Daily and what their trading volumes were on general basis as reported to Gas Daily.

So, we can either go through this, or we can go back, or if you have specific questions.

CHAIRMAN DUNN: The most important question actually, unfortunately.

Why don't we take about a five-minute break to give everybody a rest and for Evelyn to rest her fingers and change paper.

[Thereupon a brief recess was taken.]

CHAIRMAN DUNN: Why don't we get moving forward again.

We're back on the record, continuing with the testimony of Ms. Markey, subject to the same regs and remedies as we discussed earlier at the outset of your testimony, Ms. Markey.

Our apologies for interrupting. You were in the

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midst of going through some of the slides. I know there are some left. Why don't we just let you take up where we left off.

MS. MARKEY: Great, thank you, Senator.

I do want to clarify just because I want to kind of just make sure everybody is singing from the same sheet of music here, the contracts in question are -- contracts that any price manipulation would have an affect on would be contracts that were based off of an index, rather than just deals done at the spot market.

CHAIRMAN DUNN: Mr. Drivon.

MR. DRIVON: Well, it would affect the day-ahead spot market as of the time the folks show up at 6:30 or 7:30 in the morning, because I think one of your slides indicated, one of the very first things they would do would be, the traders would check Gas Daily.

MS. MARKEY: That's true, that's true. It could be said that given the next morning when the market would open, or before the market would open on the NYMEX, you could refer to any price that was published by Gas Daily to start the market off first thing in the morning.

MR. DRIVON: And then the other thing that typically traders would do at or about this time is, they would check Enron On Line.

MS. MARKEY: That's correct, to see what the bid-ask was on Enron's screen.

MR. DRIVON: And the bid-ask on Enron's screen, of course, would always reflect that Enron was going to be one of the counterparties to the transaction. That's the way it

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worked.

MS. MARKEY: That is correct.

MR. DRIVON: I mean, that's the way it was supposed to work. We found out there might not be a counterparty to some of the transactions, but at least Enron was involved in every transaction; correct?

MS. MARKEY: Yes, it was a closed system.

MR. DRIVON: And so, folks would typically check Enron On Line, which was run by, of course, Enron, who's the number one chief suspect on your list of ten.

MS. MARKEY: Yes, that is correct.

MR. DRIVON: And then, they would also check, in order to start off the day's trading, Gas Daily index, which, if what you've told us you believe to be is, in fact, true, is an index that was being misreported and manipulated; right?

MS. MARKEY: That is true.

MR. DRIVON: I did want to ask you a couple of other questions.

These reports of price, to the extent that they were inflated or just false, let me read you a section of the California Penal Code.

MS. MARKEY: All right.

MR. DRIVON: There has been some question as to whether the activities that were taking place might be a violation of the law.

Section 395 of the California Penal Code reads as follows:

"Every person who willfully

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makes or publishes any false statement, spreads any false rumor, or employs any other false or fraudulent means or device with the intent to affect the market price of any property is guilty of a misdemeanor."

Did you know that?

MS. MARKEY: No, I didn't.

MR. DRIVON: Now, you've been telling us that in your opinion, and in the opinion of others who called for audits and investigations, there were in fact false statements made in terms of what the trading prices were. Isn't that true?

MS. MARKEY: We suspected as much. We didn't know for a fact, but I sure did suspect as much.

MR. DRIVON: Right, you suspected it, and others suspected it, and that's why there was an audit called for, and the protocols put in place, and the company hired to do it.

MS. MARKEY: That's correct.

MR. DRIVON: And in your opinion, based on your experience, training, and expertise, and the position that you held, being the person in charge of acquiring these data, it is your opinion that false statements were being made. Isn't that true?

MS. MARKEY: It's my opinion. Again, I don't have clear evidence, but it is my strong opinion.

MR. DRIVON: It is your strong opinion, and you are an expert on the accumulation of these data that you've been

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talking about; isn't that true?

MS. MARKEY: Based on the information that I saw in the four years that I collected data, that is correct.

MR. DRIVON: And it's your further opinion, if I understand it correctly, that these false statements and this false reporting was being done for the purpose of affecting the market price of gas; isn't that true?

MS. MARKEY: I didn't know exactly the purpose, but you could assume that would be the purpose.

MR. DRIVON: That's your opinion as you sit here today; isn't that true?

MS. MARKEY: That is correct.

MR. DRIVON: And that's an opinion that you hold strongly; isn't that true?

MS. MARKEY: That is correct.

MR. DRIVON: The acquisition of the publications was made in August of 2001?

MS. MARKEY: That is correct.

MR. DRIVON: And that's the same month that the audit was killed; right?

MS. MARKEY: Yes.

MR. DRIVON: And when did you leave the publication?

MS. MARKEY: March 2002.

MR. DRIVON: These examples that you've given us are examples that you have put together by reviewing and analyzing the data that you have available to you; correct?

MS. MARKEY: Correct.

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MR. DRIVON: And those data are basically taken from the data that you helped accumulate in your official capacity with the publication; correct?

MS. MARKEY: That is correct.

MR. DRIVON: And in order to -- you're not telling us that these examples that you've pulled out are the only examples; are you?

MS. MARKEY: No, I'm not.

MR. DRIVON: I mean, it takes a lot of time to go through these data and try to put these sorts of things together; correct?

MS. MARKEY: Didn't take me very long.

MR. DRIVON: And if you wanted to spend more time on, it you could come up with more examples?

MS. MARKEY: Yes, I could.

MR. DRIVON: You've given us certain documents here. In fact, about three inches of them.

MS. MARKEY: Yes.

MR. DRIVON: Can you tell us basically what those documents are? What types of documents do we have there?

MS. MARKEY: Well, they're e-mails primarily in regards to the period of time when I was at Platts that were back and forth between myself and the price reporters, or from industry participants who sent in information regarding price information.

MR. DRIVON: So, the e-mails are one style of document that you have.

MS. MARKEY: Most of those were from the time

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when I was at Gas Daily, was FT Energy. After September 2001, I was no longer in charge of the price team.

MR. DRIVON: As of when?

MS. MARKEY: September 2001.

MR. DRIVON: Let's see. You're the one that was pushing for the audit?

MS. MARKEY: Yes.

MR. DRIVON: And a company came along, and the audit was going to be of Enron?

MS. MARKEY: Yes.

MR. DRIVON: That you personally suspected was the main, or at least the largest, misreporter.

MS. MARKEY: Yes.

MR. DRIVON: And so, you arranged to get these protocols done, and the company lined up, Price-Waterhouse-Cooper, and the contract's ready to be signed and all that; right?

MS. MARKEY: Yes.

MR. DRIVON: Then the company gets sold to somebody whose biggest customer for this information is Enron; right?

MS. MARKEY: Yes.

MR. DRIVON: That happens in August.

MS. MARKEY: Yes.

MR. DRIVON: Within 30 days, they take you off that job.

MS. MARKEY: Two weeks.

MR. DRIVON: Two weeks.

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And the fellow or person who replaced you probably hasn't said anything about this.

MS. MARKEY: Not that I'm aware of.

MR. DRIVON: If I understand it, Ms. Markey, you are currently under subpoena not only by this Committee, but also by other entities. Is that correct?

MS. MARKEY: That is correct.

MR. DRIVON: Including the FERC?

MS. MARKEY: Yes, sir.

MR. DRIVON: The Justice Department?

MS. MARKEY: CFTC, not the Justice Department.

MR. DRIVON: Anybody else besides CFTC and FERC?

MS. MARKEY: So far that's it.

MR. DRIVON: And the testimony that you're giving here today is testimony you haven't given in any other official forum?

MS. MARKEY: No, I have not.

MR. DRIVON: And the documents that you've shared with us, some of which we were able to look at, and some of which -- and I think the most important and incriminating documents were documents that you were willing to give to us only after immunity was confirmed; is that correct?

MS. MARKEY: That's correct.

MR. DRIVON: And those were given to us in the manner that some saw earlier, where they were actually presented to the Sergeant here in her official capacity; right?

MS. MARKEY: That is correct.

MR. DRIVON: Those are documents that have not

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been to this time to your knowledge released to others?

MS. MARKEY: No, they have not.

MR. KIRTLAND: Just to clarify, Mr. Drivon, all the documents were provided pursuant to the immunity agreement.

MR. DRIVON: I understand that.

MR. KIRTLAND: Okay. I just wanted to make sure we're on the same page.

MR. DRIVON: Oh, we are on the same page.

And not only was immunity conferred, but there is a subpoena compelling the production of those documents. So, bringing them to Sacramento was not a voluntary act on your client's part.

MR. KIRTLAND: That's correct.

MR. DRIVON: You told us earlier that some level

of price exaggeration or puffing has sort of always been involved in this process; correct?
MS. MARKEY: Yes.
MR. DRIVON: But what we're seeing here in these data that you have provided us is a whole new level of falsity; isn't it?
MS. MARKEY: It could be construed as such.
MR. DRIVON: Well, you've looked at these data for a long time, and you were central to the accumulation of these data and to the questions that were being asked about these data; true?
MS. MARKEY: Yes.
MR. DRIVON: Can you think of any other way that these data could be construed, other than a whole new level of

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manipulation was being brought to the gas market?
MS. MARKEY: I don't know any other reason why some volume would be traded at these particular levels and then reported as such.
MR. DRIVON: But it's not only the levels. It's the pattern; isn't it? In other words, the prices and volumes are being reported at the margins of the market.
MS. MARKEY: That's correct.
MR. DRIVON: Now, as I understand it, on June the 16th of 2001, there were price transactions that took place that involved Enron; is that right.
MS. MARKEY: Yes, I believe so.
MR. DRIVON: June 16th, I think that's the right date.
MS. MARKEY: PG&E and SoCal Gas large packages.
MR. DRIVON: Or was it the 19th.
MS. MARKEY: It was the 19th, actually.
MR. DRIVON: And on the 19th, as I understand it, you had occasion not only to look at the data that you have, but also the daily position reports of Enron; is that correct?
MS. MARKEY: Yes I have.
MR. DRIVON: And with respect to the daily position reports of Enron, on that day Enron was short; isn't that true.
MS. MARKEY: That is correct.
MR. DRIVON: In other words, Enron needed the price of natural gas to go down that day in order to make money; correct?

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MS. MARKEY: Correct.
MR. DRIVON: And they misreported on that day, or they reported unusual amounts of trading at unusual prices?
MS. MARKEY: I don't know specifically that this person that reported here was Enron, but one might suspect that.
MR. DRIVON: Well, let me make it really easy for you. I want you to assume it was Enron. I mean, it quacks like a duck, it walks like a duck. I mean, I want you to just assume it's a duck; okay?
MS. MARKEY: I'll assume it's a duck.
MR. DRIVON: All right. Now we've got a duck, an Enron duck. It's kind of leaning sideways as it stands there, kind of like the sign.
The way that they reported volumes and prices on that day, they needed the price to go lower to make money?
MS. MARKEY: Yes.
MR. DRIVON: The volumes and prices that were reported on that day pushed the market in which direction?
MS. MARKEY: Down.
MR. DRIVON: I'm shocked.

And therefore, based upon those trading activities, and their market position that you verified by market data and reporting data that they had internally are consistent.

MS. MARKEY: Yes.

MR. DRIVON: And they made money.

MS. MARKEY: They would, if that's the position

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that they had in Southern California.

MR. DRIVON: I'm still assuming that it's a duck.

MS. MARKEY: It's a duck.

I actually do have an example, however, specifically of a situation with Enron, if you'd like to see that.

MR. DRIVON: Absolutely. This is going to be an example of a false statement?

MS. MARKEY: It's not necessarily false, but it would have been --

MR. DRIVON: If we assume it's false, this is a statement that is going to have an affect on the market.

MS. MARKEY: What we'll show is how much Enron actually did report at one particular location. It's only one day. And what happened was, is on February the 2nd --

CHAIRMAN DUNN: I'm sorry, let me interrupt. I'm going to get everybody to the right page. Chris has a quick question, then we'll get to this.

MS. MARKEY: Sure.

CHAIRMAN DUNN: For everybody's sake, we are in that packet that was just handed out, towards the very back. The title starts, "Text from e-mail sent by David Behrman to Gas," et cetera, et cetera.

Chris.

MR. SCHREIBER: I actually just wanted to clarify.

Just a point that Larry had made about seeing Enron's DPRs, I'd actually given you a figure from the DPRs --

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MS. MARKEY: That is correct. You did not show me the exact ones. You gave me a list and said that you had pulled that from that. That is correct.

CHAIRMAN DUNN: And Chris, for clarification for everybody who's sitting here, DPR is?

MR. SCHREIBER: Daily Position Report.

CHAIRMAN DUNN: Which is, just so everybody understands, what's the significance of a DPR?

MS. MARKEY: A Daily Position Report is ultimately the net long or short position that the company holds every single day. For instance, some of the numbers that Chris gave me showed that on June 19th, Enron, according to the sheet he gave me, was short 589 bcf as far as their daily position that -- for that particular day.

If I can put that in context, the total gas supply in the U.S. every day from both Canada and U.S. production is approximately 53 bcf, which is only 10 percent of Enron's total position for that one single day.

CHAIRMAN DUNN: And being short of their DPR can tell you, at least theoretically, what their motivation may be to how that gas price should come out.

MS. MARKEY: That is correct.

CHAIRMAN DUNN: Okay.

Mr. Drivon.

MR. DRIVON: I want to put on the record at this point that use of the Daily Position Report from Enron in this fashion was at my express authorization and instruction to Mr. Schreiber for purposes of preparing witnesses who testify in

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this hearing.

MS. MARKEY: Okay.

CHAIRMAN DUNN: Ms. Markey, please, let's go to this one.

MS. MARKEY: Right. This is an e-mail text from an e-mail that I received from David Behrman, who reported to me in Houston. He was basically in charge of the actual pricing teams themselves down in Houston.

And let me just call attention to the middle paragraph that says,

"I got a call today from Patrice Thurston ... who trades Chicago and Michigan gates;"

By the way, Patrice is a trader at Enron,

"she said [that] somehow her 1.3 bcf at Chicago was left out of the sheet they sent Friday."

This is probably the only documentation that I have that actually shows how much volume a particular company actually traded as far as a name, and a number, and a location.

What I did was, if you'll flip to the next page, I actually was able to figure out what the impact of Enron's missing data was for that Chicago price for February 5th, 2001.

As you know, the prices are gathered every day and totaled up. Although not available through -- on the publication itself, on Gas Daily's website, you can actually go in and get the total volume that was reported, the aggregated total volume that was reported for a particular price point.

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You can also get the midpoint, and that's what I did here. I actually collected it for a few days so that you could get the general overall pattern of how much gas was reported at this particular location, which happens to be Chicago's citygates.

If you'll notice, on the flow date of February 1st, approximately 3.8 bcf was reported. On February 2nd, 3.6 bcf was reported. And then there's a significant drop down to 2.4, and then back up to 3 bcf, 4.2 bcf, 3.7 bcf, so forth and so on.

So, you can see that there was a definite drop in volume for the days where Enron left their volumes out of the price report for that day.

MR. SCHREIBER: Did Patrice Thurston represent all of Enron's reporting to Gas Daily for this price point, or were there other traders from Enron?

MS. MARKEY: Oh, no, there were other traders from Enron. This just -- she happened to be the one who traded Chicago and Michigan gates.

There could have been other price -- there certainly were, as there was close to 700 traders at Enron

MR. SCHREIBER: Were there others for this price point at the Chicago-Michigan gates, or was she the only Enron representative?

MS. MARKEY: In this particular instance, it sounds like she's the only one, but I cannot recall for a fact whether she was or not. There were certainly for other locations, and there were also numbers provided to us by Enron

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On Line, but I believe they all capsulized together when they -- when they reported. At least that's what they told us they did.

All right, so we're back to the slide -- and by the way, on a Friday, whenever a trader reports their prices, it's always for a three-day period. It's for Saturday, Sunday and Monday. So, all three days were missing the volume that

Enron would have reported that day.

If I can continue, I then went ahead and included Enron's volume that was -- and again, I've got this in thousands of MMBtus to stay consistent with how the data is reported. So, it looks like 1300 thousand in Btu, which is 1.3 bcf. And notice then, when you add that back in --

CHAIRMAN DUNN: I'm going to interrupt.

Just for everybody following, we're now on the "Impact of Enron's Missing Data," but Slide 2, and it's labeled as "Slide 2."

MS. MARKEY: All right.

If you'll notice with the addition of the volume, it gets the total volume for Chicago in line with all the other days that volume was reported for Chicago.

If I take that one step further, Enron --

CHAIRMAN DUNN: We're now on Enron Slide 3.

MS. MARKEY: Yes, we are now on Slide 3.

Enron On Line reported to Gas Daily through a mechanism. We had a separate stand alone index that was created sometime around March or April of 2001, whereby Enron On Line came to us and requested that we set up an index that would bring in all their prices for specific locations.

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Initially we started this index because we thought -- we being Gas Daily -- thought that we would get all the other electronic indexes to participate, such as the ICE, the Intercontinental Exchange, E Speed.

As it turned out, there was only one on line entity that provided us prices, which was Enron On Line.

So on the particular day that we're talking about here, Enron On Line turned in a price to Gas Daily of 6 dollars and 84.7 cents. So, assuming that that's all of the price that Enron would have done, since anything done on Enron On Line was always done with Enron, I added that back into the number that would have been reported for the midpoint. And you can see that the total revised volume, with the revised price, would have changed the price by almost three cents.

All this really proves is that Enron did have an influence on the market, and it gives you a concept of how much volume they could and did report at a particular location.

And you can take that assumption and carry it forward to other locations, particularly if we look at -- and this is in your documents -- the locations that they traded and reported through Gas Daily through the electronic exchange. There were approximately 10 or 12 locations where they specifically reported on an ongoing basis, and SoCal gas large packages was one of them.

CHAIRMAN DUNN: And as discussed between you and Mr. Drivon earlier, a three-cent change, according to the revisions you did here, "Total Revised Volume," and compared it, is huge.

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MS. MARKEY: I would have killed to make three cents as a trader. Not literally, of course.

MR. DRIVON: I was going to say, that's another violation of the California Penal Code.

CHAIRMAN DUNN: We understand, Ms. Markey.

Senator Johannessen.

SENATOR JOHANNESSEN: The numbers you used, the approximately 700 traders.

MS. MARKEY: Yes, sir.

SENATOR JOHANNESSEN: That Enron had, the information that we just now received, was that indicative of what they all did? Or was there some specific unit of Enron that did this?

I'm assuming they had a lot of offices, but 700 people wouldn't be in one boiler factory; would they?

MS. MARKEY: That's a very good question.

To my knowledge, the numbers at Enron were rolled up and aggregated, but I don't know how many of their subsidiaries made up those numbers. They had several different companies that actually did trade. Enron Energy Services is one; Enron Capital and Trade was another.

SENATOR JOHANNESSEN: So, am I correct in assuming then that Enron internally also traded, round robin internally? That maybe subsidiaries of Enron who then would be selling to, who then reported a higher income back in again?

MS. MARKEY: That's possible.

Certainly, when you look at capacity release, which is the trading of transportation, which is publicly

0147

available information, that did consistently happen.

SENATOR JOHANNESSEN: And that can be shown by the volumes that in fact was delivered, rather than on paper?

MS. MARKEY: As far as the trades or --

SENATOR JOHANNESSEN: Yes.

MS. MARKEY: It's a possibility, yes.

SENATOR JOHANNESSEN: Thank you.

MR. DRIVON: Let's talk about partial release for a minute, because that gets us right back to what we were talking about this morning; doesn't it?

MS. MARKEY: Yes, it does.

MR. DRIVON: So pipeline's a little bit tough for me to think about, because, you know, it's full, or it's not full, or it's only partly full, or it looks like it's full but it hasn't got anything in it, and we've got a lot of hard things to think about.

But if we compare it to an apartment building, and we say that El Paso owns this entire apartment building, and it's full of apartments.

MS. MARKEY: Correct.

MR. DRIVON: And El Paso's got to do something with all those vacant apartments.

MS. MARKEY: Yes.

MR. DRIVON: So, what they do with that is, they get their subsidiary company, Merchant, to give them a master lease on the apartment house.

MS. MARKEY: Yes.

MR. DRIVON: So now, they book a profit because

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they got the empty apartment building off to Merchant.

MS. MARKEY: Yes.

MR. DRIVON: Now, Merchant's sitting there with it, and they really don't have any native ability to rent all those apartments because they're just not that big. So, they're either taking a huge risk, or they're going to lay it off some place.

Are you with me so far?

MS. MARKEY: Yes.

MR. DRIVON: So they make a deal with Enron to actually rent all those apartments.

MS. MARKEY: Yes, they could do that.

MR. DRIVON: And then Enron, a partial release would be if Enron then goes and sublets some of those apartments. That would be a partial release, right?

MS. MARKEY: Yes, that's correct.

MR. DRIVON: So, that's kind of a rough, and I see one of those Brattle fellows back there shaking his head and kind of going like this, so I know the example is not precise, but there is an analogy there.

So, when they sublet those individual apartments, it's kind of like a partial release of pipeline capacity. Is that what you're talking about?
MS. MARKEY: Yes, that is correct.
MR. DRIVON: And so, those partial releases are also tradeable commodities; aren't they?
MS. MARKEY: Yes, they are.
MR. DRIVON: And the partial releases are the
0149
right to transport gas. A partial release would be a right to transport a certain amount of gas over the pipeline; right?
MS. MARKEY: Correct.
MR. DRIVON: Kind of like subletting an apartment would give you the right to occupy a certain part of the building.
MS. MARKEY: Yes.
MR. DRIVON: And through the use of these partial releases, somebody who had the master lease could determine what the supply of available apartments was; right?
MS. MARKEY: Yes.
MR. DRIVON: You could release more of them or fewer of them.
MS. MARKEY: You can also start splitting up the rooms within an apartment as well and sublease those in addition. It's called segmenting.
MR. DRIVON: And through those mechanisms, you can affect supply?
MS. MARKEY: Yes.
MR. DRIVON: And through the affecting of supply, you can affect price?
MS. MARKEY: Yes.
MR. DRIVON: So, if you put together partial release mechanisms with phony price reporting mechanisms, it's still a duck?
MS. MARKEY: Yes.
MR. DRIVON: Now you have at least two ways that you can manipulate the market to make money on gas; right?
0150
MS. MARKEY: Yes.
MR. DRIVON: And then, if in addition to that you happen to also trade electricity, and, say, in the fall of 2000 into the spring of 2001, this duck happened to be real long in electricity forward, and you did this stuff with the price of natural gas or some other mechanism we talked about, as well as others, you would be affecting the price of electricity as well; right?
MS. MARKEY: That is correct.
MR. DRIVON: And if you're long in electricity, and you force price up, what happens?
MS. MARKEY: If you're long in electricity, and you force the price up, if the price goes above what you originally paid for it, you make money.
MR. DRIVON: Okay. Do you think that's what happened, in your opinion?
MS. MARKEY: I think there are a lot of ways to make money in California, and that could have been one of them.
MR. DRIVON: Actually two.
MS. MARKEY: Two, yes, that's true. Yes, two.
CHAIRMAN DUNN: Did you have more?
MS. MARKEY: Actually, as far as the slides, there was the example of wash trading back on the original slide.
CHAIRMAN DUNN: Right.
MS. MARKEY: And if you kind of flip back and forth to the 2, you'll notice that in the TIPROA presentation we

start out with a quote.

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CHAIRMAN DUNN: For those who are following it, we're back into the original packet of the materials that was handed out. The slide that Ms. Markey had stopped at is entitled, "Wash Trading -- How Does It Affect the Indexes?"

MS. MARKEY: We can go through this example, and then again we can go back and look at the chart that shows a potential example of wash trading.

Basically all I did, if we stare onto the next slide, which says, "Example of How Wash Trades Could Affect Index and Create Volatility," we just simply looked to the example of Company A selling to Company B again at three dollars. Company B sells back to Company A that same 100,000 MMBtus at three dollars.

And keep in mind when this was done, more or less probably was not scheduled. It was just, again, a paper trade. Could have been done as many times as possible. This is just a one time example.

So, when it comes time for the companies to both report to the indexes, Company A reports its 200,000 MMBtus at three bucks, and Company B does the same.

Let's go on to the next slide. So, a total of 400,000 MMBtus is reported to the price survey vis-a-vis both companies.

Let's assume for a time that the total aggregated volumes of all other companies is 600,000, and an average price of 3.10 If that 400,000 had not been included, the price that would have been reported for the midpoint index that day would have been 3.10. However, with the inclusion of 400,000 at three

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dollars, it ultimately lowered the price by four cents, to 3.06.

And if I can just now step you back over to your slides again, this will be the one where it says, "Columbia, APP, August 11, 2001."

CHAIRMAN DUNN: This is where we had the two identical reports.

MS. MARKEY: That is correct.

It's probably possible to look at some of these other volumes and prices, but this one stuck out to me because it was so very high, because it was a volume that exceeded anything else that anybody else would have done, and it was done by two individuals.

The transactional data that I actually have in my data base also has a time at which these were reported. These were reported within 15 minutes of each other.

I can't say for a fact that this is a wash trade, but using Mr. Drivon's example, it sure does smell like a duck to me.

I don't really have any other examples, other than to go on to the final example or the final slide, the final two slides in the TIPROA presentation.

And this is basically the limitations of the survey itself. Unfortunately what happened with the price surveys is, they became a formalized tool that they were intended to become. There never was any formal process of tracking trades. No audits were ever conducted. And in fact, they never really captured the entire market.

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Reporters being able to subjectively cull questionable trades, there was no science to that. In other words, how did they feel that day if, in fact, they even did it at all.

And most importantly, these newsletters were in the business to report what they heard in the market for their market. The market, of course, were the largest trading houses.

There were some possible solutions. At the time I did this, I didn't realize to the extent of how many people were going to come out and start admitting as to their falsifying information.

Since then, in rethinking all this, and thinking particularly how it affects my current employer, I think it's very, very important that either at a state level or a federal level that the reporting of prices have some kind of oversight. Right now, the publications themselves truly do not have any kind of means of which to gain accurate and credible prices.

The other thing they don't have the ability to do is to publish the individual trades as they're reported, unlike what you see when you trade on the NYMEX or the New York Stock Exchange. There's no way of actually seeing the individual trades.

And as somebody mentioned to the Committee earlier, and what we've heard recently is that a lot of companies have quit reporting to the publications as whole. That is probably a more serious issue than anything else, because what are we, the producer, going to price our gas at,

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considering the Northeast indexes? And we have relied upon them after all these years, as well as a lot of utilities and the end users who do likewise.

CHAIRMAN DUNN: Would it also be saying -- and I know we've got our representatives from the PUC here as well -- without that information, it would make the setting of rates by, say, a CPUC more difficult?

MS. MARKEY: Very difficult.

MR. DRIVON: Did you know before you came here today that California law required the CPUC to use an index as part of their rating structure?

MS. MARKEY: I was aware, actually, based from my days at Nevada Power, that California had incorporated some of the indexes, but I didn't know to what extent the indexes played a part in their rate making.

MR. DRIVON: So, now we have a system of indexes that are created not for the purpose of reporting a market, but just to report what's said. And yet, those same indexes are mandated to be used in setting a price that people are going to pay out of their wallet for this commodity.

MS. MARKEY: Yes, that's true. Interestingly enough, a lot of the documents that I've provided to you gentlemen today, they're pretty much wide spread examples of not only the CPUC, but quite a number of other utilities as well as public utility commissions in other states that also use these prices for the same purposes that the CPUC does as well.

MR. DRIVON: A purpose for which it originally was not at all the intent that they be used.

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MS. MARKEY: That is correct.

MR. DRIVON: I wanted to use this opportunity to tap your expertise with respect to one other area having to do with wash trades.

MS. MARKEY: All right.

MR. DRIVON: You showed us an example few minutes ago of two transactions at identical prices, identical volumes within 15 minutes of each other. That is probably a wash trade. But that would be a very simple example of how a wash trade could be done.

In other words, Company A sells to Company B, who sells back to Company A for the same amount of money; same volume, same amount, same commodity.

MS. MARKEY: Yes.

MR. DRIVON: That's one way it can be done.

It could also be done where there was an agreement between companies to spread those transactions over time, like the next day or the next week?

MS. MARKEY: It could be that. It could be done that way.

MR. DRIVON: That would make it more difficult to track; wouldn't it?

MS. MARKEY: Yes, it would.

MR. DRIVON: In addition to that, you could work out by agreement effective wash transactions that mixed commodities, for instance, selling gas at one price and buying back electricity at a price that reflected the spark spread, and therefore neutralize the transaction.

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MS. MARKEY: That could occur, yes.

MR. DRIVON: And you could do that either on the same day, concurrently, or you could do it over time.

MS. MARKEY: Yes.

MR. DRIVON: In addition to that, if you wanted to get even more sophisticated, you could begin buying and selling for amounts that cancelled each other an almost limitless number of derivatives.

MS. MARKEY: Yes.

MR. DRIVON: Forward contracts, or delivery contracts, or pipeline capacity. And then you could mix all of those up.

MS. MARKEY: Yes.

MR. DRIVON: By agreement, you could effectively wash these trades, which cost nobody anything because all the prices for buying and selling whatever commodity is used, all cancel each other out. That's the definition of it; right?

MS. MARKEY: Correct.

MR. DRIVON: And through the use of those mechanisms, you could affect not only the gas market, you could affect also the electricity market and financial markets.

MS. MARKEY: Yes.

MR. DRIVON: If I understand it correctly, the only thing that really would prevent, to the extent that it might be prevented, that sort of activity would be the feeling of moral restraint and responsibility by whoever the company was that was considering doing it; right?

MS. MARKEY: Yes.

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MR. DRIVON: And that appears to be a commodity that was in short supply, at least during that period of time that we've been talking about, as far as you can tell.

MS. MARKEY: There was a lot of pressure on people to make a lot of money during that period of time.

MR. DRIVON: And a lot of money was made.

MS. MARKEY: Yes, there was.

MR. DRIVON: Some of the traders that were involved in these transactions, just the traders themselves, some of them became millionaires over this; didn't they?

MS. MARKEY: I've heard of that. Wasn't me or one of my friends.

MR. DRIVON: That's let alone what the companies may have made.

MS. MARKEY: Correct.

MR. DRIVON: What do you think of the idea of mandating the reporting of pricing data with the name of the parties that are involved? Names of the parties could be held confidential for some period of time, but mandatory reporting of pricing, including volumes, with criminal penalties for false reporting.

How do you think that would affect the transparency of the market?

MS. MARKEY: I think it would provide an amazing amount of transparency that we don't have available right now.

MR. DRIVON: And that kind of transparency would likely have an affect of taking away a lot of the volatility that we're seeing by reason of the opacity in the market;
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correct?

MS. MARKEY: Correct. However, the market will always be volatile to a certain extent because of weather and supply-demand features.

I think the type of excessive volatility that you saw during the period of 2000-2001 would be diminished substantially, if not completely, if prices had been made to be transparent, and more of the players and their participants be basically put in front of everybody to see.

MR. DRIVON: Well, if the kind of trading volumes that we saw in that chart that we looked at before, on this chart here, if this increase in trading volume could be explained by weather, it would be a cold day in hell; wouldn't it?

MS. MARKEY: Yes, I think that's a good explanation.

CHAIRMAN DUNN: It's similar, Michele, to the duck question.

MS. MARKEY: Similar to the duck question, yes.

CHAIRMAN DUNN: Here's what I want to do, if I may, Ms. Markey. For us lay people trying very hard to understand, obviously, the total implications of, A, what you said, and B, certainly the complexities of the profession that you've operated in now for a number of years, I just want to give a quick lay person summary to see if my understanding is somewhere in the ballpark.

Then I want to just cover real quickly, this is the first opportunity that we've had to review these documents.
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We obviously need to take time and go through them. Independently, I suspect, we'll have many follow-up questions at a later date regarding those documents.

MS. MARKEY: Yes.

CHAIRMAN DUNN: But you and/or your counsel were gracious enough to prepare a brief index to those documents as well. I just want to touch upon them so I have a general understanding of the various categories that are there.

My lay person's understanding, Ms. Markey, comes down to as follows. In listening to the testimony of both Paul and Matt earlier today, what I heard was there is the ability to impact the price of natural gas through the control of the capacity.

MS. MARKEY: That's correct.

CHAIRMAN DUNN: The PUC representatives testified that there is another very important factor on price, and that is the published indexes. And the PUC representative testified how important the published indexes are to the PUC to accomplish their tasks, as well as touching upon other important roles the indexes play within the industry.

MS. MARKEY: Yes.

CHAIRMAN DUNN: You've been gracious enough to be here for the past few hours. What I've heard you say is, in addition to that control of the capacity as a means of impacting price, the price can be impacted by, in effect, controlling the published index prices through exaggeration of volume or price, or under reporting, or not reporting at all.

And if we accept the PUC's testimony earlier,

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where those published indexes are in error, whether by fraudulent means or other deliberate acts, it's going to have a dramatic ripple effect on the pricing throughout the industry.

MS. MARKEY: Yes, that's a very true statement.

CHAIRMAN DUNN: I missed kind of the focus point of what you've been saying this afternoon?

MS. MARKEY: For a lay person, you got it right on target.

CHAIRMAN DUNN: Let me just cover real quickly the index. If you could, Counsel, if you've got a copy, or Michele, you're probably intimately familiar with it.

So we all have an understanding of what generically is contained in the documents that were produced.

MS. MARKEY: We basically divided the documents up into several different categories. Number one, examples of widespread use of Gas Daily Index, for instance, from NPR coverage, to the Massachusetts PUC, to FERC and the Cal ISO themselves using Gas Daily prices in price mitigation.

Gas Daily indexes were intensely used throughout not only the industry themselves, but also within regulatory bodies throughout the United States.

CHAIRMAN DUNN: Let's go to the Cal ISO for just a second.

MS. MARKEY: Sure.

CHAIRMAN DUNN: I believe you referenced that Cal ISO used them for price mitigation.

MS. MARKEY: Yes. I said gas cost proxy.

CHAIRMAN DUNN: In lay terms, what does that

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mean?

MS. MARKEY: Basically it means that if they didn't know exactly what the cost of gas was, they used a basket of California indices in order to price out the gas component of the cost of electricity.

CHAIRMAN DUNN: In other words, when you're dealing with the cost of electricity for the Cal ISO, one of the claims by the wholesale sellers of electricity was what they claimed to be incredibly high cost of natural gas.

MS. MARKEY: Yes.

CHAIRMAN DUNN: And in the price mitigation, determining what that gas price was, was important?

MS. MARKEY: Very important.

CHAIRMAN DUNN: And if that published gas index price was artificially high, for example, it's going to impact the mitigation process of the Cal ISO.

MS. MARKEY: Absolutely.

CHAIRMAN DUNN: All right. Again, we're just flushing out for us lay folks.

MS. MARKEY: Sure.

The next category are the categories of the possible price manipulation of the Gas Daily Index in which there are actually a couple of significant e-mails and/or letters and transcripts of conversations that we had with several companies.

I'll frankly point out that the one that's probably most critical in looking at this is the March 12th, 2001 transcript, where various electric traders at AEP called up

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David Behrman to complain that they did not want to see Enron On Line included in our transactions. And the gist of the conversation was that they knew that Enron was in the habit of manipulating prices.

Later on, there is a letter where the particular traders at AEP who had complained were, in fact, ex-Enron traders who knew that Enron provided false information.

The next set of documents, there's also, let's see, right. The next set of documents is Enron-related documents.

CHAIRMAN DUNN: I'm sorry, Michele. I'm going to take you back.

One that strikes my interest, and again, I know that this is just a brief listing of the documents. June 28th, 2001, Duke Reduces Communications with Gas Daily. What is that referring to?

MS. MARKEY: Duke used to send us a fax with all of their prices. And at this time we were also asking them to provide their forward market pricing, interestingly enough, at the suggestion of Enron and several others. And they refused to participate. In fact, were not wanting to give us any information, didn't want us calling any of the traders.

They never would give us any other reason, other than, just, we don't wish to talk with you.

CHAIRMAN DUNN: You reference, at Enron's encouragement.

MS. MARKEY: Actually, in a lot of the particular instances where Enron would come up -- this kind of relates to

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the next set of documents -- Enron was fond of calling us up and asking us to either support new products that they were creating or to actually create new price points based at their direction. In the particular example --

CHAIRMAN DUNN: Wait, would you say that sentence again.

MS. MARKEY: They were in the habit of calling us up and asking us to promote certain products that they were supporting, such as basis swaps, and they were also encouraging us to actually set up particular price points.

CHAIRMAN DUNN: All right.

MS. MARKEY: And the one where it was a response with Duke, I believe Duke was one of the parties that they wanted us to talk to about doing a certain basis spot swap product, and they had us actually get them to participate in providing this information and price data for that.

Which does get us to the next set of Enron-related documents, which is kind of two-fold. One, it does talk about how Enron had to do with the creation of the AECO Same-Day price hub. In effect, Enron gave us the methodology and dictated to us how that price index was going to be created. And we set it up at basically their behest.

Although we did encourage the industry to send us their feelings about this, we basically went with the Enron methodology on how to set up the particular AECO price point, called AECO Same-Day.

CHAIRMAN DUNN: We'll call that the Enron Hub?

MS. MARKEY: A lot of people used to call us

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Enron Daily, and there was a reason for that.

In addition, throughout most of these e-mails, there are detailed plans for establishing the electronic trading indexes which, as I explained earlier, was initially going to be a basket of all various different companies who reported electronically, but ultimately became only EOL, and ultimately was the whole reason why AEP quit reporting to us, because they thought that Enron was going to be providing us false data through that particular electronic index.

Additionally, this is what we ultimately tried to audit Enron on, was their information that they provided to us

on this electronic exchange.
CHAIRMAN DUNN: Senator Johannessen.
SENATOR JOHANNESSEN: Thank you.
How many subsidiaries or businesses did Enron control? Sounds to me like they're a spider sitting in the web, and tentacles reaching out. And most of them, in order to survive or whatever, that they would go along with Enron.
MS. MARKEY: Yes, actually there's another e-mail incorporated in this set where it's an announcement that NGX, which is the Canadian Exchange for AECO, also was planning to include Enron On Line's numbers, as well as Houston Street, which was another electronic exchange.
So they did -- they touched all of us.
SENATOR JOHANNESSEN: I appreciate that. I just want to tell you, for a while now I have been listening to more horse pucky than I like to think. It's refreshing to someone filling in the blanks. We expected as much, but really
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appreciate someone coming out to do that.
MS. MARKEY: Thank you, sir.
SENATOR JOHANNESSEN: There's a lot of effort on your part, I know, and it takes a lot of backbone to do it. I just want you to know we appreciate it, because I think we've got it pretty well lined up who the bad guys were, and I hope that they get the appropriate due.
But I thank you personally, because I really appreciate the fact that you come out to do this.
CHAIRMAN DUNN: Michele, there's one, and it's your Number 10 under the Enron-related documents, December 1st, 2000, includes statements that producers prefer nontransparent prices.
MS. MARKEY: Yes. Actually, this was an e-mail that was supposedly a public document that was talking about Enron's establishment of their on line exchange. And within the e-mail, it talks about how Enron On Line was going to provide more price transparency to the market, and that producers were deathly afraid of Enron On Line, because for many years, they enjoyed the benefits of nontransparent prices.
Frankly, I think that's rather than ironic in this time and age that they would have made a statement like that when, in fact, they were encouraging the exact opposite.
CHAIRMAN DUNN: If you'd continue going through.
MS. MARKEY: Right.
I think that pretty much -- oh, there is one other thing. Enron came to us in I believe it was March of
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2001, and they wanted us to start up another set of indices for industrial products. They wanted us to get into pulp, paper, lumber, metals. They had a whole grocery shopping list that they wanted FT Energy to set up similar to the way we had set up Gas Daily. And there's a significant amount of back and forth, of us looking at that. And because we were in the process of being acquired, we never took it any place.
CHAIRMAN DUNN: I think Mr. Drivon wants to hunt some ducks.
MR. DRIVON: One of the commodities that they were talking about indexing and trading was water; wasn't it?
MS. MARKEY: Yes.
MR. DRIVON: So now they're going to get indexes going that make sure we stay warm enough, that we can see at night, and we have something to drink.
And Enron, by the way, they weren't all by themselves in all of this misreporting of prices, and of all these other shenanigans we've been talking about. I mean, they

had company; didn't they?
MS. MARKEY: Yes.
MR. DRIVON: And that little list of ten suspects up there is what you, in your opinion, believe their main company to have been?
MS. MARKEY: Yes.
MR. DRIVON: We've talked a lot about Enron here, but we're not doing that because we want to leave out anybody, are we? We want to be fair.
MS. MARKEY: Well, the next set of documents that
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we have was some -- a board of discussions that we were having with Williams.
Williams had a rather unique idea. They had a whole list of Gas Daily price points that they wanted to basically put in a basket and create a thing called the UE Index, which I believe stood for Universal Energy.
And the only reason we didn't go forth with it was because they were going to combine it with other data they had internally, and they would not let me see the formula as to how they were going to use our data as well as their own data. So I said, until you provide me the actual formula, I'm not going to give you the Gas Daily process.
Interestingly enough, on Energy News Live, which is their website that they wanted to put this out -- and they also wanted us to publish this index as well in their publication -- they ended up publishing a UE Index.
And I can't tell you to this day how they used it or why they used it, but I suspect it was going to be their kind of answer of, here in arbitrage, we're going to use Gas Daily basket and trade these baskets, and we're going to ask you to buy on our UE Index, and guess what? We're the only ones who know how the formula works, so we're kind of the ones holding the bag, more or less.
So, we backed away from it.
So now, I don't mean to just necessarily point out Enron, but Williams did try to jump in the ball game fairly late as well.
CHAIRMAN DUNN: In other words, no really "trust
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us," justification.
MS. MARKEY: That's correct.
MR. DRIVON: Back to their moral imperative that they were so responsive to; right?
MS. MARKEY: Yes.
Last but not least, one of the other attempts while I was at FT Energy was, I thought if we at least put all the individual transactions that people would report to us during the day out on our real-time website, where people would see the transactions as they were being reported, that maybe people would be a little less likely to exaggerate or try to manipulate prices.
That product was developed and was in beta test. Several companies did very enthusiastically jump up and become beta testers, two of which was Dynegy and El Paso.
Interestingly enough, when I went to Enron's office, I only had a chance to demo in front of the techie guys. I never got in front of the traders. And the techie guys just didn't see any value in it.
But a number of the other trading houses saw immediately. In fact, CMS Energy would have signed up had ultimately the product been taken off the shelf.
So, one of the things that I believe Dynegy and El Paso at least had the benefit of through the beta test was that they could see each one of the individual transactions as

it was being reported, and ultimately knew what the ultimate index would have been, which is actually where a lot this data comes from that you guys now have, is from backups to the beta

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test.

MR. DRIVON: Let me take a wild guess.

This was an attempt that you were making to try to get some mediation into this false reporting, manipulation process; right?

MS. MARKEY: I was trying to show the Emperor's clothes were not there.

MR. DRIVON: Yes, and my while guess is, you ran into the same spot as the audit?

MS. MARKEY: Yes.

MR. DRIVON: And then because, or maybe because, they didn't want you to have any more pipe dreams, they took you off that desk.

You don't need to answer that question.

CHAIRMAN DUNN: Michele, I want to go to the last category of documents that you've got listed, that you listed as general. Just real quickly, the October 5th, 2000, Enron Reliance Sole Contributors to Electric Forward Pricing Table, what is that one?

MS. MARKEY: Oh, right. We were going to start, or we did start, an electric forwards pricing table. And in this, we established where some of the information was going to be coming from.

And to get started, we were going to basically just use Enron and Reliance faxes that they sent to us every day in order to put forward a forwards market price. So, they would basically be the two contributors giving us the prices.

CHAIRMAN DUNN: What I want to do at this point,

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I want to just take about five minutes so I can discuss with both Larry and Chris if we have any follow-up questions, there may be just a few. So, why don't we take just five minutes, everybody, and then we'll wrap up quickly after that.

MS. MARKEY: Thank you.

[Thereupon a brief recess was taken.]

CHAIRMAN DUNN: Why don't we get you back in and try to wrap it up here. I have just a few questions first.

I want to go back to Gas Daily.

MS. MARKEY: Yes.

CHAIRMAN DUNN: To your knowledge, Ms. Markey, was management at Gas Daily aware of the potential of exaggerated reporting occurring, resulting in their publication of incorrect data?

MS. MARKEY: Yes.

CHAIRMAN DUNN: And at any time are you aware that they took any actions to correct that situation?

MS. MARKEY: I'm not aware of any.

CHAIRMAN DUNN: At any time did Gas Daily undertake any efforts to investigate for future use to ensure the accuracy of the data that it reported?

MS. MARKEY: As far as pursuing a plan?

CHAIRMAN DUNN: We could do it that way.

The question really is, okay, I'm Gas Daily. I'm aware that we're getting inaccurate reports, exaggerated reports.

MS. MARKEY: Yes.

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CHAIRMAN DUNN: From this point forward, did Gas Daily take any steps to investigate the reports that it received?

MS. MARKEY: Yes. There was an example. In fact, in January 10th of 2001, this is one of the letters, and it had to do with price discovery in Chicago. And we had a utility complain bitterly about the high prices. And we went to Enron, and to Aquila, Reliant, PG&E, National, and tried to get them to give us their transactional data.

CHAIRMAN DUNN: And they would not?

MS. MARKEY: And they would not.

CHAIRMAN DUNN: And that was the end of that investigation?

MS. MARKEY: That's as far as you can normally take it.

CHAIRMAN DUNN: So, despite the fact that it couldn't even complete its investigation, it just continued publishing its data in the same way?

MS. MARKEY: Yes.

CHAIRMAN DUNN: To your knowledge, did FERC or any state PUC, for that matter, ever question the validity of the prices reported in the indexes?

MS. MARKEY: No. As a matter of fact, they thought they were the most accurate out there. In fact, when FERC chose Gas Daily, they chose Gas Daily over several other publications because, supposedly, the prices were so accurate and reliable.

CHAIRMAN DUNN: Do you know if any entity ever

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complained or reported to FERC its concerns about the inaccuracy of the Gas Daily published prices?

MS. MARKEY: I'm not personally aware, no.

CHAIRMAN DUNN: Have you heard that through any source, that someone may have complained to FERC directly?

MS. MARKEY: I've heard, but I don't know any specifics.

CHAIRMAN DUNN: Are you aware if FERC ever made inquiry to Gas Daily about the accuracy of its published prices?

MS. MARKEY: No, not that I'm aware of.

CHAIRMAN DUNN: I know you're not there now, but have you heard even up to today whether FERC has explored this issue?

MS. MARKEY: Yes, they actually have subpoenaed Platts for documents regarding prices.

CHAIRMAN DUNN: Do you know approximately when that subpoena was served? Again, I know you're not there.

MS. MARKEY: Sometime in September.

CHAIRMAN DUNN: So, several months ago.

MS. MARKEY: Yes.

CHAIRMAN DUNN: Any other subpoenaes that you are aware of that have been issued on Platts from any source?

MS. MARKEY: Not that I'm aware of.

CHAIRMAN DUNN: Mr. Drivon.

MR. DRIVON: I just want to take this opportunity to say that I personally, and on behalf of all the rest of us who have worked on this for so long, because as you know, this Committee has been working on this piece for almost a year now,

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and I want to express my personal appreciation to you for the courageous move that you've made in coming forward with these documents and this testimony.

I suspect and I believe that you suspect that there may be some personal price that you'll have to pay for having done this. And I want to tell you that I recognize and commend you for what I believe to have been a very valuable public service, not only to the people of the State of California, but to the people across the United States, because this is an issue that most people don't realize the magnitude of in terms of what it costs each individual person and the economy.

So, thank you very, very much.

MS. MARKEY: Thank you.

CHAIRMAN DUNN: Michele, I want to underscore what Larry just said. As indicated, I think we met quite sometime ago now, and we've had many discussions along the way.

You've been a tremendous source of education, I know, for those of us who have dealt with you. I, too, appreciate the fact that you've come forward today.

Counsel, it's also my understanding that we're going to keep this record open, and that there will be a follow-up submission. Counsel, if you would comment, please.

MR. KIRTLAND: That's correct. We're going to submit a set of the documents that we gave you that's base leveled, so there'll be individual sequential numbers.

And then, there will also be, perhaps, any further important points that Michele thinks is necessary to put

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on the record.

Our understanding is, once we make that submission, which should be in the next couple of days, then the record will be closed.

CHAIRMAN DUNN: Yes. We will, as we oftentimes do here as we'll do today, we will not adjourn the meeting. We will recess, and the submission that you're referring to will be considered part of Michele's testimony, subject to the same contiuums as we talked about at the outset of her testimony regarding this presiding officer compelling that testimony under 9410, and then the same rights and remedies applying to that as well. It will be a continuation of her testimony.

MR. KIRTLAND: Correct.

CHAIRMAN DUNN: And then the record will be closed at that point in time.

Mr. Drivon.

MR. DRIVON: Unless the Committee decides that further testimony may be valuable, in which case we will notify you so that arrangements can be made for further response to the subpoena.

CHAIRMAN DUNN: And it will be, of course, done through you, Counsel.

MR. KIRTLAND: Right, that's fine. You have our contact information.

MR. DRIVON: What I want to be sure we do is that we don't foreclose further testimony by this witness without the necessity of further subpoena. We don't envision that at this point, but that may be, and if it is, we will contact you to

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arrange for that at a convenient time.

MR. KIRTLAND: That's fine.

CHAIRMAN DUNN: Let me close simply by offering a heart-felt thank you to you, Michele, for coming here today. I know you've come a long way.

Counsel, I know you've come a long way.

Also to Paul and to Matt. You two have also come an extraordinarily long way to assist the Committee today in our continued investigation and understanding of what occurred here in California. It helps tremendously as we move forward with crafting legislative solutions here at the state level.

Also to Bill and to Trina as well from the PUC, we appreciate your presence here as well.

Without anything further from the Committee, we are recessed at this time. Thank you.

[Thereupon this portion of the Senate Select Committee hearing

was terminated at approximately.
4:55 P.M.]

--ooOoo--

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CERTIFICATE OF SHORTHAND REPORTER

I, EVELYN J. MIZAK, a Shorthand Reporter of the State of California, do hereby certify:

That I am a disinterested person herein; that the foregoing transcript of the hearing of the Senate Select Committee to Investigate Price Manipulation on the Wholesale Energy Market was reported verbatim in shorthand by me, Evelyn J. Mizak, and thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for any of the parties to said hearing, nor in any way interested in the outcome of said hearing.

IN WITNESS WHEREOF, I have hereunto set my hand this ______ day of __________________, 2002.

____

EVELYN J. MIZAK
Shorthand Reporter